CLIENT ALERT

Second Round of Opportunity Zone Guidance Closes Holes in O-Zone Layer

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Proposed regulations released on April 17, 2019 (the "April Regulations") provide further guidance on the opportunity zone ("OZ") rules in section 1400Z-2 of the Internal Revenue Code. These rules, enacted as part of the Tax Cuts and Jobs Act, are designed to encourage investments in low-income communities designated as qualified opportunity zones ("QOZs"). The April Regulations supplement proposed regulations released on October 19, 2018.[1]

In general, under the OZ rules taxpayers may be able to defer certain gains until the end of 2026 by investing in equity interests ("eligible interests") of a qualified opportunity fund ("QOF"), reduce the deferred gain by up to 15% by meeting certain holding period requirements, and permanently exclude any new gain on a QOF investment held for at least 10 years.

Noteworthy aspects of the April Regulations, which are described in further detail below, are as follows:

- An interest in a QOF partnership issued to a partner in exchange for services (*i.e.*, a carried interest) cannot qualify for OZ benefits.

- A portion of a QOF interest received in exchange for an in-kind contribution of property in certain cases may not qualify for OZ benefits.

[1] Please see our client alerts addressing the statutory OZ rules and the October proposed regulations.

- A taxpayer with eligible gains may make a qualifying investment by purchasing QOF interests from another investor, rather than directly from the QOF.
- Eligible gains which can be deferred under the OZ rules include the excess, if any, of gains over losses from section 1231 property (generally, property used in a trade or business).
- In general, a taxpayer must include deferred gain in income upon any transfer that reduces the taxpayer's equity interest in a QOF (including through an upper-tier entity), or any receipt of property from a QOF that is treated as a distribution for tax purposes. A debt-financed distribution by a QOF partnership will result in an inclusion event only to the extent the distribution exceeds the taxpayer's basis (including basis attributable to partnership liabilities).
- The basis adjustments that allow an investor to exclude gain from the sale of an interest in a QOF partnership after 10 years are applied in a manner that avoids producing gain from relief of fund-level liabilities or ordinary income as a result of depreciation recapture.
- An investor in a QOF that is taxed as a partnership, S corporation or REIT may exclude capital gain from the QOF's sale of its QOZ property, not just from the investor's sale of QOF interests.
- The working capital safe harbor has been expanded to cover the development of a trade or business in the QOZ as well as the acquisition, construction, and/or substantial improvement of tangible property. The safe harbor is still available if delays beyond the required 31-month period are attributable to waiting for government action. Finally, a business may benefit from multiple overlapping or sequential applications of the safe harbor.
- A QOZ business may rely on one of three safe harbors to satisfy the requirement that it derive at least 50% of its total gross income from the active conduct of a trade or business within a QOZ. These safe harbors address concerns of businesses with operations inside, but customers outside, the QOZ.
- The 90% QOF asset test can be applied without taking into account certain property recently contributed to the QOF. Satisfaction of the test is also not affected by QOF asset sales so long as the proceeds are reinvested within 12 months.
- Under a general anti-abuse rule, the IRS can recast a transaction intended to achieve a tax result that is inconsistent with the purposes of the OZ rules.

In general, taxpayers may currently rely on the April Regulations (as was the case with the October proposed regulations), so long as the rules are applied consistently and in their entirety.

Investor Level Guidance

No benefits for carried interest. An interest in a QOF partnership issued in exchange for services (*i.e.*, a carried interest) does not qualify for OZ benefits (a “non-qualifying investment”), even if the partner contributed amounts corresponding to eligible gains to the QOF. In this case, the partner would (solely for purposes of the OZ rules) be treated as holding two separate partnership interests, only one of which would qualify for tax benefits (the “qualifying investment”).

In-kind contributions. The OZ rules are often described as requiring a “rollover” of gains into a QOF, but no tracing of particular proceeds is required. For example, a taxpayer who sells stock for $150 that was originally purchased for $50 may defer up to the amount of the $100 gain by investing in a QOF using (1) cash proceeds from the stock sale, (2) cash from other sources, or (3) an in-kind contribution of property.

In general, an investor is treated as making a qualifying investment to the extent of his or her basis in the contributed property (or, if less, its fair market value), provided such amount does not exceed the investor’s eligible gain. If the contributed property has a built-in gain, the gain portion is treated as a non-qualifying investment, with a basis that preserves the built-in gain. The contribution to a QOF partnership of property subject to debt is treated as a qualifying investment to the extent of the lesser of the property’s net value (value minus debt) or net basis (basis minus debt). An investor may recognize gain on the transfer of property to a QOF in exchange for an eligible interest, but this gain may not be deferred under the OZ rules.

Disguised sales. A taxpayer does not have a qualifying investment in a QOF partnership to the extent the taxpayer’s in-kind transfer of property to the partnership is characterized as a sale. In addition, the amount of a taxpayer’s qualifying investment may be reduced if the taxpayer’s contribution of cash or property is tied too closely to a partnership distribution, determined under rules for disguised sales (with certain modifications). This rule might come into play, for example, if the QOF partnership made a planned debt-financed distribution to an investor shortly after the investor’s contribution to the partnership.

Acquisitions from another person. A taxpayer can make a qualifying investment by acquiring a QOF interest from an existing shareholder or partner. The amount of the qualifying investment is equal to the amount of cash or the value of other property exchanged for the QOF interest (limited in all cases to the amount of eligible gain subject to the applicable deferral election). However, the taxpayer may not elect to defer any gain recognized on a transfer of property to acquire a QOF interest from another person.

Section 1231 gains. In general, section 1231 treats gains and losses from the sale or exchange of property used in a trade or business as long-term capital gain if gains exceed losses, and as ordinary loss if losses exceed gains. Because the capital gain income from section 1231 property cannot be determined until the last day of the taxable year, the 180-day period for investing such capital gain income in a QOF begins on the last day of the taxable year.

Inclusion events. Subject to numerous exceptions, two general principles apply to determine when a taxpayer must recognize gains deferred under the OZ rules (and thus forfeit any further OZ tax benefits with respect to the qualifying investment): (1) any transfer that reduces the taxpayer's equity interest in the qualifying investment, and (2) any receipt of property from the QOF in a transaction that is treated as a distribution for tax purposes.

The first type of inclusion event includes a sale or other taxable disposition of all or part of a qualifying investment in a QOF, or of an interest in an upper-tier partnership or S corporation that owns a qualifying investment in a QOF (in the case of an S corporation, only if the transfer results in a greater than 25% change in ownership). A transfer by gift—but not a transfer at death—is also treated as an inclusion event.

The second type of inclusion event includes a distribution by a QOF partnership to the extent the distribution exceeds the partner's basis. This confirms that a QOF partnership may make debt-financed distributions to its partners without causing an inclusion event, under the general rules of Subchapter K. The second type of inclusion event also includes a distribution or redemption by a QOF corporation that is treated as a sale or exchange of stock.

Certain non-recognition transactions are also inclusion events, including transactions that involve the elimination of the QOF corporation, such as the tax-free liquidation into a parent corporation. However, a non-recognition transfer of an interest in a QOF partnership to another partnership is generally not an inclusion event, provided that the recipient partnership specially allocates any gain from the contributed qualifying investment to the contributing partner. Certain asset reorganizations and spin-off and split-off transactions involving a QOF are also not inclusion events.

The amount included in income as a result of an inclusion event generally equals the deferred gain with respect to the portion of the investment that is sold (or, if less, the fair market value of that portion). For example, if a taxpayer sells 25% of a $500 qualifying investment when the taxpayer's basis in the investment is zero, the taxpayer will generally need to include 25% of the $500 deferred gain, or $125, in income (or, if less, the fair market value of the 25% portion of the interest that is sold).

Calculation of gain exclusion after 10 years. An investor selling an interest in a QOF partnership after 10 years may adjust the basis to equal the fair market value of the interest "including debt." This appears to be a reference to the portion of the investor's basis that is derived from partnership debt, and thus would permit a step-up to the gross fair market value of the interest. For example, assume that a QOF partnership has $400 of gross asset value and $100 of liabilities allocable to a particular investor. The investor would realize $400 on a sale of the interest: $300 sales proceeds representing the net value plus $100 from relief of liabilities. The April Regulations appear to permit an increase in the investor's basis that includes the debt-financed portion of the investment (to $400 in this example), so that the investor could exclude all gain on the sale.

In addition, immediately before the sale or exchange, the QOF partnership would adjust its "inside" basis in its assets so that the investor would not have ordinary income (and a corresponding capital loss) as a result of depreciation recapture.

Exit through QOF's sale of QOZ property. To date, QOFs have generally been structured based on the understanding that an investor may exclude gain after 10 years only on the sale of QOF interests. The April Regulations permit an investor in a QOF that is taxed as a partnership, S corporation or REIT to exclude capital gain from the QOF's sale of its QOZ property. In the case of a QOF REIT, the exclusion occurs through a specially designated capital gain dividend that is subject to a zero rate of tax. Sales by a QOF, however, do not appear to benefit from the provisions, described above, that avoid producing gain from relief of fund-level liabilities or ordinary income as a result of depreciation recapture. In addition, the provisions permitting investors to exclude gain from a QOF's sales of QOZ property do not appear to apply to gain arising from a sale of assets by a QOZ business in which the QOF invests.

Consolidated groups. The Treasury Department and IRS have concluded that section 1400Z-2 and the consolidated return system would be incompatible without an extensive system of rules to effectuate the disparate purposes of each. Therefore, the April Regulations state that although a QOF corporation may be the common parent of a consolidated group, a QOF corporation cannot be a subsidiary member of a consolidated group.

The requirements of the OZ rules generally apply separately to each member of a controlled group, so that to qualify for deferral of gain, each member of the group would need to sell a capital asset giving rise to capital gain and timely invest up to that amount in a QOF. However, adjustments to basis and other tax attributes will "tier up" to upper-tier members, to prevent duplication of gains and losses within the group.

QOF Qualification

Reinvestment within 12 months. A QOF must hold at least 90% of its assets in QOZ property—QOZ business property, or shares in a corporation or interests in a partnership that is a QOZ business—based on the average of the amount invested on the last day of the first six-month period and on the last day of each taxable year of the QOF (the "90% test").

A QOF may treat proceeds from the sale or disposition of QOZ property as satisfying the 90% test if the proceeds are reinvested in QOZ property within 12 months and are continuously held in cash, cash equivalents or debt instruments with a term of 18 months or less ("working capital assets"). As with the working capital safe harbor, the reinvestment period can be extended if failure to meet the 12-month deadline is attributable to delay in government action, the application for which is complete. This rule preserves the fund's status as a QOF, and avoids penalties that would otherwise apply, but does not affect the normal tax consequences of the distribution, sale or disposition, such as a QOF partnership's allocation of gain to investors. It should be noted that this rule only applies to distributions or reinvestments by a QOF itself, as opposed to any subsidiary of a QOF.

Contributions within prior six months may be ignored in applying the 90% test. A QOF may apply the 90% test without taking into account any investments received in the six months preceding the testing date, provided that the new assets are continuously held in working capital assets. This adds to the flexibility provided in the October proposed regulations, which permit a new QOF to delay the starting date for its status as a QOF, so that it can prepare to deploy capital before the capital is received and tested. Further, it provides greater flexibility for the QOF to hold assets for some period of time before subjecting those assets to a 31-month working capital deployment schedule of a subsidiary QOZ business.

Penalties for failure to satisfy the 90% test. The April Regulations note that administrative rules for a QOF that fails to satisfy the 90% test will be issued within a few months. However, the explanation of provisions in the April Regulations notes that failure to satisfy the 90% test on a testing date—even the first testing date—does not by itself cause an entity to fail to be a QOF.

QOZ Property and QOZ Business Requirements

Meaning of trade or business. For purposes of determining whether a business is a QOZ business, the "active conduct of a trade or business" is defined to reflect the meaning of such term under section 162 of the Code (relating to business expenses). The April Regulations also specify that the "active conduct of a trade or business" includes the ownership and operation (including leasing) of real property (but does not include the mere entering into of a triple net lease with respect to real property owned by the QOF).

Expansion of working capital safe harbor. The working capital safe harbor, which permits a QOZ business to hold working capital assets for up to 31 months pending investment in qualifying assets, has been expanded to cover the development of a trade or business in the QOZ, including, when appropriate, the acquisition, construction, and/or substantial improvement of tangible property. In addition, the safe harbor will still be available if working capital assets are not used within 31 months, and the delay is caused by governmental action, the application for which is complete. Finally, a QOZ business may benefit from multiple applications of the safe harbor. The safe harbor, however, is only available to a QOZ business, and does not apply to a QOF's direct investments in QOZ business property.

Active conduct of a trade or business within a QOZ. A QOZ business may rely on one of three safe harbors to satisfy the requirement that it derive at least 50% of its total gross income from the active conduct of a trade or business within a QOZ. A QOZ business is treated as meeting the 50% requirement if at least 50% of the services performed by the employees and independent contractors of the business are performed within the QOZ, as measured by (1) hours worked (under the first safe harbor) or (2) amounts paid by the QOZ business for such services (under the second safe harbor). The third safe harbor is met if the tangible property of the business located in the QOZ and the management and operational functions of the business performed within the QOZ are each necessary to produce at least 50% of the gross income of the business. A QOZ business that fails to meet any of these safe harbors may also look to all of the facts and circumstances to determine whether the 50% requirement is met.

Use of intangible property. A QOZ business must also use a “substantial portion” of its intangible property in the active conduct of its trade or business in the QOZ. For this purpose, the April Regulations define “substantial portion” as at least 40%, but without providing detail on how this is to be measured.

Definitions of “substantially all” as used in section 1400Z-2. The April Regulations define the term “substantially all” under a variety of tests within section 1400Z-2. “Substantially all” is defined as at least 70% for purposes of testing whether business property is sufficiently used within a QOZ to constitute QOZ business property (whether such property is owned or leased). In addition, a safe harbor prevents failure of the use requirement merely because inventory is in transit from a vendor, or to a customer, outside the QOZ.

QOZ business property must satisfy the 70% use test above during “substantially all” of the holding period of a QOF or QOZ business. In addition, a subsidiary held by a QOF must qualify as a QOZ business during “substantially all” of the QOF’s holding period. The term “substantially all” when used for these holding period requirements is defined as at least 90%. The preamble indicates that this approach was intended to prevent dilution of the “substantially all” concept due to a layering of relatively low thresholds.

Definition of and rules relating to the “original use” of QOZ business property. The proposed regulations indicate that tangible property’s “original use” is considered to begin on the date that a person first places the property in service in the QOZ for depreciation or amortization purposes. Therefore, a QOF or QOZ business must generally be the first to place such property into service in the QOZ for depreciation and amortization purposes to satisfy the original use requirement. However, the “original use” requirement can be met with respect to real property that has been vacant for at least five years before being purchased by a QOF or QOZ business.

Determining whether leased property is QOZ business property. Substantially all of the tangible property “owned or leased” by a QOZ business must be QOZ business property. The April Regulations provide guidance on when leased property is treated as QOZ business property, with a goal of creating parity in the treatment of leased property and owned property. Possession of the leased property must be first acquired through a lease entered into after December 31, 2017, and substantially all (at least 70%) of the use of the leased tangible property must be in a QOZ during substantially all (at least 90%) of the period during which the business leases the property. The lease must also be on arm’s-length terms.

Unlike owned property, leased property is not subject to an original use or substantial improvement requirement. A QOF or QOZ business may also enter into a lease with a related party, but only if certain additional requirements are met: the lessee may not prepay more than 12 months of rent and, if the lease relates to tangible personal property whose original use does not commence with the lessee, the lessee must acquire ownership of additional QOZ business property with a value that is greater than or equal to the value of the leased property within 30 months from acquiring possession of the leased property (or before expiration of the term of the lease, if sooner).

Leased property may be valued based on an applicable financial statement or by discounting scheduled rental payments using the applicable federal rate.

General Anti-Abuse Test

A general anti-abuse rule permits the IRS to recast a transaction if a significant purpose of the transaction is to achieve a tax result that is inconsistent with the purposes of the OZ rules. According to the preamble, the anti-abuse rule could apply, for example, if a QOF acquired land utilized by a business for the production of an agricultural crop, with the intention to treat the land as QOZ business property without making any new capital investment in, or increasing any economic activity or output of, the land.

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