New Treasury Proposal May Help Investors Get To Land Of OZ

By **Lisa Zarlenga and John Cobb** (April 25, 2019, 3:49 PM EDT)

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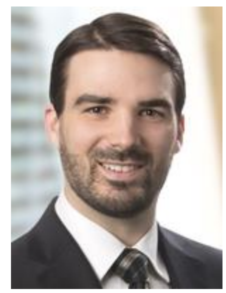

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Qualified opportunity zones, or QOZs, are a creature of the so-called Tax Cuts and Jobs Act[1] and provide three tax benefits to encourage economic growth and investment in distressed communities: (1) deferral of gain recognition to the extent a taxpayer elects to invest a corresponding amount in a qualified opportunity fund, or QOF, (2) exclusion from income of up to 15% of that gain — 10% after five years and an additional 5% after seven years and (3) exclusion from income of certain post-acquisition gains on investments in the QOF held for at least 10 years.[2]

The U.S. Department of the Treasury and the Internal Revenue Service issued an initial set of proposed regulations on Oct. 19, 2018, that provided guidance on the types of gains that qualify, the requirements for investing in the QOF and the requirements for the QOF to invest in qualified opportunity zone property.[3] However, many questions remained, creating uncertainty for QOFs and investors. On April 17, Treasury and the IRS issued their second round of proposed regulations, which addresses many of these unanswered questions and provides helpful guidance so that QOZ investments can move forward. This article highlights some of the more significant changes.

Initial Investments by Investors and QOFs

In general, investors have 180 days from the date on which capital gain would be recognized for federal income tax purposes — without regard to the deferral under the QOZ rules — to reinvest proceeds into a QOF.[4] A QOF must then invest in QOZ property, which consists either of interests — stock or a partnership interest — in a qualified opportunity zone business, or QOZ business, or directly held qualified opportunity zone business property, or QOZ business property.[5] In general, a QOF is required to hold 90% of its property as QOZ property, which is measured both at the end of the first six-month period of the QOF’s taxable year and at the end of the QOF’s taxable year.[6]

Flexibility in Structuring Initial Investment in QOF

Although it seemed clear that investors could acquire their QOF interests for cash equal to the amount of the deferred gain, it was unclear whether contributions of property or services were permitted. The new regulations clarify that investors may make a qualifying investment in a QOF through the contribution of property — either taxable or tax-free.[7] As a result, investors can spend their cash from the sale giving rise to the deferred gain and make the QOF investment using some other asset. In addition, an investor can purchase a QOF interest from another QOF investor.[8] However, the contribution of services — e.g., a carried interest — will not qualify.[9]

Additional Time for QOF to Invest in QOZ Property

Under the first round of proposed regulations, it appeared that a QOF that received investments immediately prior to a measurement date would have a very short period of time to acquire QOZ property for purposes of the 90% test. The new regulations provide relief by permitting the QOF to apply the 90% test without taking into account any investments received within the last six months that are held in cash, cash equivalents or short-term debt instruments.[10] This effectively gives QOFs between six and 12 months to make investments in QOZ property.

Section 1231 Property: Potential Trap for the Unwary

Section 1231 property, which generally consists of depreciable property held for use in a trade or business, receives special treatment under federal tax law. Net gains from the sale of Section 1231 property are taxed as long-term capital gain while net losses are taxed as ordinary losses.[11] The new regulations clarify that net Section 1231 gains are eligible for deferral under the QOZ rules.[12]

However, the new regulations set up a potential trap for the unwary. The new regulations provide that the 180-day period for investing Section 1231 net gains does not begin until the last day of an investor's taxable year, because that is when net amount of Section 1231 gain or loss can be determined.[13] However, investors who made QOF investments before the end of the year will not qualify, even if there was only a remote chance that they would have offsetting Section 1231 losses during the year. It would be helpful if a rule similar to that for partners electing deferral of partnership gains, which permits the 180-day period to run from the last day of the partnership's taxable year or the date of sale, could be extended to Section 1231 gains.[14]

Treatment of Deferred Gains

Outside Basis and Debt Allocation

In general, the statute achieves deferral and subsequent elimination and inclusion of invested gains by adjusting the investor's basis in the QOF investment. Initially there was a lot of confusion about how this basis tracking would work in the context of Subchapter K of the Internal Revenue Code where the QOF is a partnership. An investor's basis in a partnership interest is important because it generally determines the amount of depreciation and other deductions and losses that may be allocated to the investor, as well as the amount of tax-free distributions that the investor may receive from the partnership.

The new regulations clarify that an investor's outside basis in a QOF partnership is the same basis for all federal tax purposes.[15] The basis starts at zero and is increased by an investor's share of partnership liabilities of the QOF and by income allocated to the investor under the ordinary rules of Subchapter K. Basis is also increased under the QOZ rules in years five, seven and 10. Deductions and losses generally may be allocated to the investor to the extent of any increases to basis, and any actual or deemed distribution of cash or other property with a value in excess of the partner's basis in the QOF is treated as an inclusion event that triggers a proportionate amount of deferred gain. The preamble to the new regulations further clarifies that the QOF's inside basis in its assets is not adjusted to zero but is determined under Code Section 723 — i.e., a carryover basis.[16]

As a result, QOF partnerships should generally be able to use debt to unlock the ordinary tax benefits of partnership investments, such as allocations of partnership depreciation deductions. However, taxpayers and their advisers will need to be sensitive to downward basis adjustments, such as those caused by a decrease in an investor's share of partnership liabilities.

Investors May Recognize Interim Gains Under Ordinary Tax Principles

When a partnership sells an underlying asset or investment, it generally recognizes gain or loss on the sale, which flows up to the investors in the partnership.[17] Commenters were concerned that the flow-through of gain could trigger the investors' deferred gains. Even if it did not trigger the deferred gain, however, the effect of flow-through taxation is to cause the investor to recognize gain in an amount that could equal the deferred gain. Commenters thus requested that Treasury and the IRS use their regulatory authority to prescribe rules to ensure that a QOF has a "reasonable period of time to reinvest … proceeds received from the sale or disposition of [QOZ Property]" in order to preserve the QOZ tax benefits.[18]

The new regulations provide partial relief — as long as the QOF reinvests proceeds from the disposition of QOZ property within 12 months, the proceeds from sale may be treated as QOZ property for purposes of the 90% test.[19] However, Treasury and the IRS did not believe they had the authority to turn off the flow-through taxation of the gain but asked for comments on this point.[20]

Tangible Property Requirements

In order to be treated as QOZ business property, tangible property held by a QOF or a QOZ business generally must be acquired by purchase after Dec. 31, 2017, and must either satisfy the original use test or the substantial improvement test.[21] Property is treated as substantially improved if, during the 30-month period beginning after the acquisition, the QOF makes additions to the basis of the property that double the amount of the basis at the beginning of the 30-month period.[22]

Original Use Test

The new regulations provide that the "original use" of tangible property commences on the date any person first places the property in service in the QOZ for purposes of depreciation or amortization, even if the property has previously been used outside the QOZ.[23]

In addition, the new regulations provide a special rule that where a building or other structure has been vacant for at least five years prior to being purchased by a QOF or QOZ business, it will satisfy the original use requirement.[24] Such a rule permits vacant buildings to be put to productive use in the QOZ without having to make substantial improvements.

Facilitating Leases

The new regulations include some helpful rules regarding leased property. In particular, the new regulations do not require a lessee to substantially improve and do not impose an original use requirement with respect to leased tangible property.[25] In addition, leases can be between related parties.

To qualify, the lease must be entered into after Dec. 31, 2017, and must be a "market rate lease" that is at arm's-length under Section 482 principles.[26] In addition, for leases of real property other than unimproved land, there cannot be, at the time the lease is entered into, a plan, intent or expectation for the real property to be purchased by the lessee for an amount of consideration other than the fair market value determined at the time of the purchase, without regard to any prior lease payments.[27]

Related-party leases are subject to additional rules. First, the lessee cannot prepay more than 12-months' rent.[28] Second, if the original use of the property does not commence with the lessee, the lessee must acquire QOZ business property with a value equal to the value of the leased personal property within 30 months.[29] That property can be unrelated to the leased property.

10-Year Basis Step-Up for QOF Partnerships

In most cases, the most valuable QOZ tax benefit is the exclusion of post-acquisition gain of QOF investments held for 10 years. The statute provides that, in the case of an investment in a QOF held for at least 10 years for which the taxpayer makes an election, "the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged."[30] The new regulations include two key provisions that will help investors receive this important benefit.

Flexibility on Structuring Exit from Investments

The language of the statute seems to contemplate that the investor will sell the QOF interest at the end of 10 years. However, this is not the typical way in which most multi-asset investment funds structure exits from investments. Because an investor may not wish to exit from all of the underlying investments in a fund at the same time, exits are often structured as a sale of assets or equity at the fund or portfolio company level, rather than a sale by investors of their interests in the fund.

The new regulations provide flexibility to permit exits from investments at the fund level by allowing an investor who has held an investment in a QOF for at least 10 years to elect to exclude from gross income capital gain from the disposition of QOZ property reported on the Schedule K-1 that the investor receives from the QOF.[31] Presumably this rule also is intended to apply to dispositions at the QOZ business level, but the new regulations are not clear.

Limiting Negative Consequences of Hot Asset Rules

The new regulations also provide guidance that should help prevent the so-called "hot asset" rules of Section 751 from effectively undoing the benefits provided by the 10-year basis step-up rule. The hot asset rules could cause investors who otherwise would be able to exit from a QOF tax-free after 10 years to recognize ordinary income offset by a capital loss to the extent that the QOF held hot assets — including property subject to depreciation recapture.[32] Because capital losses generally can only offset $3,000 of ordinary income each year, the offsetting capital loss generally would not be usable by most investors.

The new regulations provide that, when an investor sells a qualifying investment in a QOF partnership after the 10-year holding period, a special deemed adjustment is made to the inside basis of QOF partnership assets so as to mimic a cash purchase of the investment when a Section 754 election is in effect.[33] This rule appears to mitigate the potential negative consequences of the hot asset rules.[34] Because the hot asset rules generally lead to recognition of ordinary income to the extent the basis of hot assets is less than their value, these deemed adjustments should reduce ordinary income that otherwise would be triggered under the hot asset rules.

Guidance for Operating Businesses

One of the biggest complaints about the first set of proposed regulations was that they did not provide clarity for operating businesses. The new regulations provide some much-needed guidance.

The statute generally requires a QOZ business to derive at least 50% of its gross income from the active conduct of a trade or business, to use a substantial portion of its intangible property in the active conduct of a trade or business and to limit its nonqualified financial property to less than 5% — excluding certain working capital.[35] The first set of proposed regulations included a working capital safe harbor, which generally allowed a QOZ business to be treated as meeting these requirements — plus the 70% tangible property requirement — for up to 31 months, if (1) there is a written plan that identifies working capital as property held for the acquisition, construction or substantial improvement of tangible property in a QOZ, (2) there is a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months and (3) the business substantially complies with the schedule.[36]

New Safe Harbors for Gross Income Test

The first set of proposed regulations introduced a requirement that this income must come from the active conduct of a trade or business in the QOZ.[37] As a result, sourcing rules are required to determine when income will be treated as derived from a business in the QOZ, which would be particularly difficult for certain operating businesses to satisfy.

The new regulations provide three new safe harbors for this rule, as well as a facts and circumstances test.[38] Under the safe harbors, a QOZ business may meet the gross income test if: At least 50% of the services performed by employees or independent contractors — based on hours — are performed in the QOZ, at least 50% of the amount paid for services are for services performed by employees or independent contractors in the QOZ, or the tangible property and management and operational functions needed to produce 50% of gross income are located in the QOZ.

Expansion of Working Capital Safe Harbor

The new regulations extend the working capital safe harbor to operating businesses. It now includes the development of a trade or business in a QOZ, more generally, including when appropriate the acquisition, construction or substantial improvement of tangible property.[39]

Treatment of Inventory in Transit

To address the concern that inventory in transit would be counted against a QOF for purposes of the 90% test, the new regulations clarify that inventory — including raw materials — of a trade or business does not fail to be used in a QOZ solely because the inventory is in transit from a vendor to a trade or business in a QOZ, or from a trade or business in a QOZ to customers that are not located in a QOZ.[40]

Substantial Improvement of Property

Many commenters had requested that Treasury and the IRS implement rules allowing certain property to be aggregated for purposes of the substantial improvement test. This would be particularly helpful for operating businesses for which it may be impractical to track improvements on an asset-by-asset basis.

The new regulations did not adopt an aggregation rule. The preamble confirmed that the test "is made on an asset-by-asset basis," but noted that Treasury and the IRS are studying this issue and requested comments.[41] It is also worth noting that the rules adopted in the new regulations relating to original use and leasing provide additional flexibility to operating businesses, so that they may not need to rely as much on the substantial improvement test.

Conclusion

The new regulations include guidance on a wide variety of critical issues for funds and investors. Although some open questions remain, there is cause for optimism that these additional proposed regulations will reduce investor uncertainty, allowing more capital to flow into qualified opportunity zones.

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[1] Pub. L. No. 115-97, 131 Stat. 2054, 2184 (2017).

[2] Section 1400Z-2(b)(2)(B),-2(c).

[3] 83 Fed. Reg. 54,279 (Oct. 29, 2018).

[4] Section 1400Z-2(a)(1)(A).

[5] Section 1400Z-2(d)(2).

[6] Section 1400Z-2(d)(1).

[7] Prop. Reg. Section 1.1400Z2(a)-1(b)(9)(i).

[8] Prop. Reg. Section 1.1400Z2(a)-1(b)(9)(iii).

[9] Prop. Reg. Section 1.1400Z2(a)-1(b)(9)(ii).

[10] Prop. Reg. Section 1.1400Z2(d)-1(b)(4).

[11] Section 1231(a)(1), (a)(2).

[12] Prop. Reg. Section 1.1400Z2(a)-1(b)(2)(iii).

[13] Id.

[14] Prop. Reg. Section 1.1400Z2(a)-1(c)(2)(iii).

[15] See Prop. Reg. Section 1.1400Z2(a)-1(b)(10)(iv) (providing examples); Preamble to Proposed Regulations, at *44. As of the date of this publication, the new proposed regulations have not yet been published in the Federal Register. Pinpoint cites are based on

the pagination of the document as released by the IRS.

[16] Preamble to Proposed Regulations, at *47.

[17] Section 702.

[18] Section 1400Z-2(e)(4)(B).

[19] Prop. Reg. Section 1.1400Z2(f)-1(b). To qualify for this relief, the proceeds must be continuously held in cash, cash equivalents, or short-term debt.

[20] Preamble to Proposed Regulations, at *35–36.

[21] Section 1400Z-2(d)(2)(D).

[22] Section 1400Z-2(d)(2)(D)(ii).

[23] Prop. Reg. Section 1.1400Z2(d)-1(c)(7).

[24] Id.

[25] See Prop. Reg. 1.1400Z2(d)-1(c)(4)(i)(B); Preamble to Proposed Regulations, at *20–21.

[26] Prop. Reg. Section 1.1400Z2(d)-1(c)(4)(i)(B)(2).

[27] Prop. Reg. Section 1.1400Z2(d)-1(c)(4)(i)(B)(6).

[28] Prop. Reg. Section 1.1400Z2(d)-1(c)(4)(i)(B)(3), (4).

[29] Prop. Reg. Section 1.1400Z2(d)-1(c)(4)(i)(B)(3), (5).

[30] Section 1400Z-2(c).

[31] Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(ii)(A)(1).

[32] See Reg. Section 1.751-1(a)(2).

[33] Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(i).

[34] Preamble to Proposed Regulations, at *45.

[35] See Section 1400Z-2(d)(3)(A)(ii) (incorporating the requirements of Section 1397C(b)(2), (4), and (8)).

[36] Prop. Reg. Section 1.1400Z2(d)-1(d)(5)(iv).

[37] Prop. Reg. Section 1.1400Z2(d)-1(d)(5)(i).

[38] Prop. Reg. Section 1.1400Z2(d)-1(d)(5)(i)(A), (B), (C), and (D).

[39] Prop. Reg. Section 1.1400Z2(d)-1(d)(5)(iv)(A).

[40] Prop. Reg. Section 1.1400Z2(d)-1(c)(4)(iii).

[41] Preamble to Proposed Regulations, at *15.