Larry's Tax Law

Opportunity Zone Funds - Part IV: The Second Round of Proposed Regulations

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On April 17, 2019, Treasury issued its second installment of proposed regulations relating to Qualified Opportunity Zones ("QOZs"). The regulations are 169 pages in length, and (as suspected) are fairly complex. Nevertheless, Treasury addresses a significant number of important QOZ issues.

We will dive into the proposed regulations in some detail in subsequent blog posts. In this post, however, we provide a high-level overview of some of the more significant provisions in the proposed regulations.

Definition of "Substantially All"

The first set of proposed regulations defines the phrase "substantially all" for purposes of determining whether an entity is a QOZ business ("QOZB"). Treasury failed, however, to define this very phrase in the context it is used in other parts of the QOZ statute.

The phrase "substantially all" also appears in Code Section 1400Z-2(d)(2)(D)(i)(III), which provides that for property to be treated as QOZ business property ("QOZBP"), "substantially all of the use of such property" must be in a QOZ. The new proposed regulations provide that the phrase substantially all in the context of "use" is 70 percent.

The new proposed regulations also define the phrase "substantially all" as it is used in the holding period context as 90 percent. *See* Code Sections 1400Z-2(d)(2)(B)(i)(III), 1400Z-2(d)(2)(C)(iii), and 1400Z-2(d)(2)(D)(i)(III).

Original Use of Tangible Property

Tangible property acquired by purchase must have its "original use" in a QOZ commencing with a qualified opportunity fund ("QOF") or QOZB, or be substantially improved, in order to qualify for tax benefits under Code Section 1400Z-2. The new proposed regulations provide the following with respect to the original use requirement:

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- The original use of tangible property acquired by purchase starts on the date when the purchaser or a prior person first places the property in service in the QOZ for purposes of depreciation or amortization (or first uses the property in the QOZ in a manner that would allow depreciation or amortization if that person were the property's owner).
- Tangible property (other than land) located in the QOZ that has not yet been depreciated or amortized by a taxpayer other than the QOF or QOZB satisfies the original use requirement.
- Used tangible property will satisfy the original use requirement with respect to a QOZ so long as the property has not been previously used (that is, has not previously been used within that QOZ in a manner that would have allowed it to be depreciated or amortized) by any taxpayer.
- Where a building or other structure has been vacant for at least five years prior to being purchased by a QOF or QOZB, the purchased building or structure will satisfy the original use requirement.
- Improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property for the amount of the unadjusted cost basis of such improvements pursuant to Code Section 1012.
- If land within a QOZ is acquired by purchase (as defined in Code Section 179(d)(2)) after December 31, 2017, the requirement that the original use of tangible property in the QOZ commence with a QOF does not apply to the land (improved or unimproved). Unimproved land so purchased is also not required to be substantially improved.
- Land can be treated as QOZBP only if it is used in a trade or business of a QOF or QOZB. The determination of whether a trade or business exists is made pursuant to Code Section 162. Holding land for investment, in and of itself, does not give rise to a trade or business; consequently, such land is not QOZBP.
- The determination of whether the substantial improvement requirement is satisfied for tangible property that is purchased is made on an asset-by-asset basis.

Safe Harbor for Testing Inventory in Transit

The new proposed regulations clarify that inventory does not fail to be used in a QOZ solely because it is in transit from a vendor to a trade or business facility in a QOZ, or from a trade or business facility in a QOZ to customers of the trade or business located outside of a QOZ.

Treatment of Leased Tangible Property

The following, generally taxpayer-favorable provisions apply to leased tangible property under the new proposed regulations:

- Leased tangible property may qualify as QOZBP for purposes of satisfying the 90-percent asset test and the substantially all requirement if two criteria are met: (1) the property is acquired under a lease entered into after December 31, 2017; and (2) substantially all of the use of the property is in a QOZ during substantially all of the period for which the business leases the property.

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- No original use or substantial improvement requirements are imposed with respect to leased tangible property.
- Tangible property may be leased from a related lessor, subject to certain limitations: (1) no prepayment of rent must be made for a period of use greater than 12 months; and (2) leased tangible personal property will not qualify as QOZBP unless the lessee owns QOZBP with a value at least as great as the value of the leased property.
- Leases of tangible property must be "market rate" in order for the property to qualify as QOZBP.
- Leased real property will not qualify as QOZBP if at the time the lease was entered into, there was a "plan, intent, or expectation" that the property would be purchased by the QOF other than at fair market value determined without regard to prior lease payments.
- Leased property must be valued either: (1) annually, based on financial statements; or (2) up front, based on the "present value" of the lease at the time the lease is entered into.

Real Property Straddling QOZs

The proposed regulations allow a business that owns property straddling a QOZ to treat the property outside the QOZ as located within a QOZ if certain requirements are met. We will address these requirements in a future blog post.

50% of Gross Income Test

A corporation or partnership must derive at least 50% of its total gross income from the active conduct of a business within a QOZ to qualify as a QOZB. The new proposed regulations provide four alternative tests to determine whether the 50% test is met. Sufficient income is derived from a trade or business in a QOZ if:

- At least 50% of the services performed (based on hours) for the business by its employees and independent contractors are performed within the QOZ;
- At least 50% of the services performed (based on amounts paid for such services) for the business by its employees and independent contractors are performed in the QOZ;
- Both (1) the tangible property of the business that is in a QOZ, and (2) the management or operational functions performed for the business in the QOZ, are each necessary to generate 50% of the gross income of the trade or business; or
- Based on all the facts and circumstances, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ.

Furthermore, the new proposed regulations provide that Code Section 162 applies to determine whether a trade or business exists for purposes of Code Section 1400Z-2. 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 section 1400Z-2(d)(3), but merely entering into a triple-net lease does not qualify.

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Intangible Asset Use

Under the statute, a substantial portion of the intangible property of a qualified business entity must be used in the active conduct of a trade or business in the QOZ with respect to any taxable year. The new proposed regulations provide that a substantial portion means at least 40%.

90% Asset Test

The proposed regulations allow a QOF to apply the 90% asset test without taking into account any investments received in the preceding 6 months, provided the investments are in the form of cash, cash equivalents, or debt instruments with a term of 18 months or less.

Reinvestment Rule

Code Section 1400Z-2(e)(4)(B) authorizes Treasury to promulgate regulations to ensure that a QOF has "a reasonable period of time to reinvest the return of capital" from investments in QOZ stock ("QOZS") and QOZ partnership interests ("QOZPIs") and proceeds received from the sale or disposition of QOZBP. The new proposed regulations provide that proceeds received by the QOF from the sale or disposition of QOZBP, QOZS, and QOZPIs are treated as QOZ property ("QOZP") for purposes of the 90-percent investment requirement, so long as the QOF reinvests the proceeds during the 12-month period beginning on the date of the sale or disposition. Until reinvestment, the proceeds must stay in the form of cash, cash equivalents, or debt instruments with a term of 18 months or less.

Note: The tax community requested that Treasury issue regulations that exempt dispositions of QOZP by QOFs or QOZBs from immediate taxation if the proceeds from such dispositions are reinvested within a reasonable timeframe. Treasury preliminarily determined that it does not have authority to provide such guidance.

Amount of Investment

The new proposed regulations provide that if a taxpayer transfers property other than cash to a QOF in a carryover basis transaction, the amount of the investment equals the lesser of the taxpayer's adjusted basis in the equity received in the transaction or the fair market value of the equity received in the transaction.

Any transfer recharacterized as a disguised sale will not be eligible for deferral.

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The following special rules treat certain transfers as mixed fund investments: (1) a mixed-funds investment will result if a taxpayer contributes to a QOF, in a nonrecognition transaction, property that has a fair market value in excess of the property's adjusted basis; and (2) a mixed-funds investment will result if the amount of the investment that might otherwise support an election exceeds the amount of the taxpayer's gain eligible for deferral. A portion of mixed-fund investments will not be eligible for deferral or exclusion of gain on appreciation.

Inclusion Events

The new proposed regulations enumerate dispositions that will trigger inclusion of gain ("inclusion events"), including the following: (1) taxable dispositions of a QOZPI or QOZS; (2) taxable dispositions of interests in an S corporation which holds QOZS or QOZPIs if, immediately after the disposition, more than 25% of the aggregate ownership interests in the S corporation have changed hands; (3) most gifts; (4) distributions to partners of property with a value in excess of outside basis; (4) certain distributions from corporations to the extent they are treated as sales or exchanges; (5) certain redemptions and liquidations; and (6) certain enumerated nonrecognition transactions.

Basis Adjustments

Under the new proposed regulations, the basis increases provided for taxpayers who hold QOF investments for five and seven years are adjustments to basis for all purposes. Thus, for example, losses suspended under Code Section 704(d) are available to the extent of the basis increases.

In the case of dispositions of QOZPIs, adjustments to the basis of the QOF partnership's assets are made in a similar manner as if the partnership had a Code Section 754 election in effect.

Amount Includible

When an inclusion event occurs, the taxpayer will generally include in gross income the lesser of the following two amounts, minus the taxpayer's basis: (1) the fair market value of the investment that is disposed of; and (2) the proportional amount of the remaining deferred gain.

Partnership and S Corporation Provisions

The proposed regulations provide a number of special rules with respect to partnership and S corporation interests, including the following:

- The transfer of a QOZPI (or an interest in a partnership that holds a QOF investment) will generally be an inclusion event, although a transfer in a Code Section 721 transaction generally will not be an inclusion event.
- Mixed-fund investments will create two sets of basis for purposes of Code Section 1400Z-2, based on capital contributions allocable to investments eligible for deferral and those that are not eligible.

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- Code Section 704(c) principles will apply to partnership allocations to prevent shifts of built-in gains or losses between investments eligible for deferral and those that are not eligible.
- Special rules will apply to profits interests received for services.
- The distribution of money from a QOF partnership will generally not result in gain except to the extent the distribution exceeds the partner's outside basis.
- The distribution of property from an S corporation is an inclusion event to the extent the distributed property has a fair market value in excess of the shareholder's outside basis.
- If an S corporation that is an investor in a QOF has an inclusion event, the S corporation shareholders will recognize gain.
- Conversions of S corporations holding QOF investments into C corporations, and conversions of C corporations holding QOF investments into S corporations, are generally not inclusion events. Conversions of S corporations holding QOF investments to partnerships or disregarded entities are generally inclusion events.
- Holders of QOZPIs or S corporation QOZS may elect to exclude from gross income capital gain from the disposition of QOZP if the disposition occurs after the 10-year holding period.

Transfers by Gift or on Death

Under the new proposed regulations, transfers by gift (including charitable contributions), except to certain grantor trusts, will be inclusion events. Transfers by reason of death (including termination of grantor trusts on the death of the grantor) will generally not be inclusion events.

Transfers to Disregarded Entities and Nonrecognition Transactions

Transfers to disregarded entities will generally not be inclusion events. A transfer of a QOF's assets in an acquisitive asset reorganization under Code Section 381(a)(2) will not generally be an inclusion event if the acquiring corporation is a QOF within a prescribed period of time, except to the extent the taxpayer receives boot.

Additional rules address other nonrecognition transactions and the treatment of boot with respect thereto.

Distributions and Contributions

Distributions treated as sales or exchanges with respect to QOZS and QOZPIs will generally be inclusion events. Transfers of QOZS or partnership interests under Code Section 351 will generally be inclusion events.

Holding Periods

For purposes of the five-, seven-, and ten-year holding periods, a taxpayer's holding period in the QOF investment will generally not tack from property transferred to the QOF, except in the case of certain reorganizations. The recipient of a QOF investment by gift that is not an inclusion event, or by reason of death, may tack the donor's or decedent's holding period.

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Anti-Abuse Rule

Code Section 1400Z-2(e)(4)(C) grants the Secretary authority to prescribe rules to prevent abuse. The new proposed regulations provide that the IRS Commissioner may recast a transaction if, based on all facts and circumstances, a significant purpose of the transaction is to achieve a tax result inconsistent with the purposes of Code Section 1400Z-2.

Additional Provisions

The new proposed regulations provide additional rules not discussed above, including:

- The application of Code Section 1400Z-2 to corporations under the consolidated return regulations;
- Additional provisions with respect to various reorganizations and partnership mergers; and
- Rules regarding entities organized under tribal law.

Conclusion

The new proposed regulations are fairly comprehensive and generally taxpayer-friendly. We will continue to sift through the regulations and offer additional insights. Stay tuned!

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