

SECOND TRANCHE OF OPPORTUNITY ZONE REGS INFORMATION

The second tranche of guidance provides answers to many questions and includes information that will help guide investors, fund managers and others. Much of the guidance responds to recommendations provided by many commentators in written comments and public testimony, including written recommendations and public testimony provided by the [Opportunity Zones Working Group](#). Some of the key guidance provided is described below and grouped into the following categories: [operating business](#), [investor](#), [fund operations](#), [real estate](#), [corporations](#) and [open items](#).

Operating Businesses

- **Measuring 50 percent of gross income in OZs.** The first tranche of proposed regulations require that at least 50 percent of the gross income of a qualified OZ business be derived from the active conduct of a trade or business in the OZ. The second tranche of regulations provide guidance on how to comply with the 50 percent requirement. Treasury provided three safe harbors and a facts and circumstances test:
 - At least 50 percent of the services performed (based on hours) for such business by its employees and independent contractors (and employees of independent contractors) are performed within the qualified OZ.
 - At least 50 percent of the services performed for the business by its employees and independent contractors (and employees of independent contractors) are performed in the qualified OZ, based on amounts paid for the services performed.
 - The tangible property of the business that is in a qualified OZ and the management or 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.

Taxpayers not meeting any of the three safe harbor tests may meet the 50-percent requirement based on a facts and circumstances test if, based on all the 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.

- **Leased property.** Under the statute, OZ property must be “purchased.” However, the substantially all test for qualified OZ businesses refers to tangible property owned or leased. The proposed regulations provide that:
 - Improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property.
 - Leased tangible property may be treated as qualified OZ business property for purposes of satisfying the 90 percent asset test and the 70 percent substantially all requirement, if:
 - Leased tangible property is acquired under a lease entered into after December 31, 2017.

- Substantially all of the use of the leased tangible property is in a qualified OZ during substantially all of the period for which the business leases the property.
 - An original use requirement does not apply with respect to leased tangible property.
 - There is not a requirement for a lessee to “substantially improve” leased tangible property.
 - Leased tangible property does not need to be acquired from a lessor that is unrelated to the QOF or qualified OZ business that is the lessee under the lease. However,
 - The lease under which a QOF or qualified OZ business acquires rights with respect to any leased tangible property must be a “market rate lease.”
 - If the lessor and lessee are related,
 - Leased tangible property is not treated as 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.
 - Leased tangible personal property is not treated as qualified OZ business property unless the lessee becomes the owner of tangible property that is qualified OZ business property and that has a value not less than the value of the leased personal property.
 - The proposed regulations include an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property (other than unimproved land).
 - Leased tangible property may be valued using either an applicable financial statement valuation method or an alternative valuation method. Once a QOF or qualified OZ business selects one of those valuation methods for the taxable year, it must apply such method consistently to all leased tangible property valued with respect to the taxable year.
 - *Financial statement valuation method* - Under the applicable financial statement valuation method, the value of leased tangible property of a QOF or qualified OZ business is the value of that property as reported on the applicable financial statement for the relevant reporting period. The proposed regulations require that a QOF or qualified OZ business may select this applicable financial statement valuation only if the applicable financial statement is prepared according to U.S. generally accepted accounting principles (GAAP) and requires recognition of the lease of the tangible property.
 - *Alternative valuation method* - Under the alternative valuation method, the value of tangible property that is leased by a QOF or qualified OZ business is determined based on a calculation of the “present value” of the lease payments for the use of the tangible property.
- **Intangible property.** The proposed regulations provide that, for purposes of determining whether a substantial portion of intangible property of a qualified OZ is used in the active conduct of a trade or business, the term substantial portion means at least 40 percent.

- **Reasonable working capital definition.** The first tranche of proposed regulations created a reasonable working capital safe harbor for qualified OZ businesses to acquire, construct and/or substantially improve tangible property. However, new and expanding operating businesses also need working capital to cover expenditures such as payroll, inventory and occupancy costs during the startup phase. The second tranche of proposed regulations change the written designation for planned use of working capital to now include the development of a trade or business in the qualified OZ as well as acquisition, construction, and/or substantial improvement of tangible property.
- **Substantial improvement and aggregation of assets.** Qualified OZ business property must have its original use in an OZ with a QOF or a qualified OZ business, or the QOF or qualified OZ business must substantially improve the property. Property is treated as substantially improved by the QOF or a qualified OZ business only if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the QOF or qualified OZ business exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF or qualified OZ business. To facilitate the qualification of an existing operating business as a qualified OZ business, it would be quite helpful if, at the election of the taxpayer, the substantial improvement requirement could be met by an operating business on an aggregate basis—where the acquisition of tangible property over any 30-month period exceeds the aggregate adjusted basis of existing tangible property held by the business at the beginning of a 30-month period. Unfortunately, under the proposed regulations the determination of whether the substantial improvement requirement is satisfied for tangible property that is purchased is made on an asset-by-asset basis.
- **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 from a vendor to a facility of 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.

Investor

- **Investments are cash or property, not services.** The guidance provides that investments in QOFs must be cash, or property, and does not include services. For property contributions, the deferral election is limited to the tax basis of the property contributed. The value received by an investor for the appreciated property or provision of services is treated as property contributed for which an election is not made, and consequently the investor has a mixed funds investment.
- **Treatment of IRC Section 1231 gains.** Section 1231 gains are required to be netted with Section 1231 losses to determine the amount, if any, of capital gains a taxpayer has. This brought into question when the 180-day window to invest Section 1231 gains begins, and whether partnerships can invest gross Section 1231 gains into a QOF. The proposed regulations provide that because the capital gain income from Section 1231 property is determinable only as of the last day of the taxable year, the 180-day period for investing such capital gain income from Section 1231 property in a QOF begins on the last day of the taxable year.

- **10 percent and 5 percent basis step-ups.** The proposed regulations clarify that the 10 percent and 5 percent basis step-ups is basis for all purposes and, for example, losses suspended under Section 704(d) would be available to the extent of the basis step-up.
- **10 Year basis step-up.** For 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 partner had purchased the interest for cash immediately prior to the transaction and the partnership had a valid Section 754 election in effect. The regulations state that this will permit basis adjustments to the QOF partnership's assets, including its inventory and unrealized receivables, and **avoid the creation of capital losses and ordinary income on the sale.** This last observation is very significant for renewable energy investors.
- **Events that cause inclusion of deferred gain (inclusion events).**
 - The regulations provide a nonexclusive list of 11 inclusion events and the 11th inclusion event, "certain nonrecognition transactions," includes another 11 events.
 - Transfers by gift are one of the 11 inclusion events.
 - As such, transfers by gift will generally be inclusion events.
 - However, a transfer of a qualifying investment by gift by the taxpayer to a trust that is treated as a grantor trust of which the taxpayer is the deemed owner is not an inclusion event.
 - A transfer of the qualifying investment to a deceased owner's estate and a distribution by the estate to the decedent's legatee or heir are not inclusion events. In each case, the recipient of the qualifying investment has the obligation, as under Section 691, to include the deferred gain in gross income in the event of any subsequent inclusion event, including for example, any further disposition by that recipient.
 - Of additional note, to be covered in Part II of this blog post, the regulations provide:

"an actual or deemed distribution of property (including cash) by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event **only to the extent** that the distributed property has a fair market value in **excess of the partner's basis** in its qualifying investment." (emphasis added)

Fund Operations

- **Entity qualification.** An entity "organized in" one of the 50 states includes an entity organized under the law of a federally recognized Indian tribe if the entity's domicile is located in one of the 50 states.
- **Definition of substantially all.** The proposed regulations address the meaning of "substantially all" in the various places where it appears in the statute.
 - The term substantially all is 70 percent for the "use in an OZ" threshold that must be met for tangible property to be qualified OZ business property.

- The term substantially all is also 70 percent for the tangible property “owned or leased” threshold that must be qualified OZ property for a business to be a qualified OZ business.
- The term substantially all is 90 percent when used to measure a QOF’s holding period of tangible property as qualified OZ business property, or an interest in a business as a qualified OZ partnership interest or qualified OZ stock, and 90 percent to measure the holding period of a qualified OZ business of tangible property as qualified OZ business property.
- **Six months to invest.** The proposed regulations provide QOFs six months to invest capital received from investors. Prior to this guidance, QOFs could have as little as one day to invest capital received from investors. More specifically, the proposed regulations allow a QOF to apply the test without taking into account any investments received in the preceding six months. The QOF’s ability to do this, however, is dependent on those new assets being held in cash, cash equivalents, or debt instruments with terms of 18 months or less.
- **90 percent and 70 percent asset test.** Last year’s initial tranche of proposed regulations mandated that QOFs and qualified OZ businesses use GAAP to calculate compliance with the 90 percent and 70 percent asset tests, if they have applicable financial statements. This second tranche of regulations walk back this mandate and allow QOFs and qualified OZ businesses to elect to use unadjusted cost basis to value tangible property regardless of whether or not they have an applicable financial statement.
- **Time to reinvest interim gains for purposes of 90 percent test.** If qualified OZ property is sold for cash, it is no longer a qualified investment for the 90 percent test—but the OZ statute allows a reasonable time to reinvest. Treasury has clarified that a “reasonable time,” is within 12 months.
- **Exit approach in wind-down period.** The OZ statute provides a fair-market-value step-up benefit only if a taxpayer sells its investment in a QOF. That requirement is counter to the way funds generally unwind. The proposed regulations provide a special election for certain sales of assets of a QOF partnership or QOF S corporation. A taxpayer that holds a 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 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. Note, the Treasury Department and the IRS intend to implement targeted anti-abuse provisions with respect to this election.
 - Special rule for REITS - The proposed rules authorize QOF real estate investment trusts (QOF REITs) to designate special capital gain dividends, not to exceed the QOF REIT’s long-term gains on sales of qualified OZ property.

Real Estate

- **Substantial improvement requirement for unimproved land.** The proposed regulations provide that the requirement that the original use of tangible property in the qualified OZ commence with a QOF is not applicable to land, whether the land is improved or unimproved. Likewise, land does not need to be substantially improved. (But note: Land must be used in a trade or

business, and would not qualify if held for investment.) The Treasury Department and the IRS request comments on whether anti-abuse rules, in addition to the general anti-abuse rule, are needed to prevent transactions such as “land banking” by QOFs or qualified OZ businesses, and on possible approaches to prevent such abuse.

- **Original use.** Under the proposed regulations, “original use” of tangible property commences on the placed in service date for purposes of depreciation or amortization.
- **Original use requirement and vacant buildings.** The proposed regulations provide that a property’s history of prior use is disregarded if the property has been vacant for at least five years.
- **31-month working capital safe harbor—issues beyond taxpayer’s control.** The proposed regulations provide qualified OZ businesses with a 31-month safe harbor to hold funds, but make no provision to extend that period for issues beyond their control. It is not uncommon for real estate and other developments to experience delays that are beyond the businesses control—such as delayed permitting and other municipal approvals, contract disputes, supply embargoes, labor stoppages, extreme weather events and national disasters. Additional flexibility is needed to give investors comfort that businesses experiencing these unforeseen delays will not be disqualified. The proposed regulations create some additional flexibility in that the regulations provide that 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 completed during the 31-month period.
- **Multiple 31-month working capital safe-harbors.** The second tranche makes clear that business may benefit from multiple overlapping or sequential applications of the 31-month working capital safe harbor.
- **Residential rental property and triple net leases.** Guidance was needed as to whether renting property pursuant to a triple-net lease can be an active trade or business and final confirmation was desired that operating residential rental property can be an active trade or business. The proposed regulations provide that 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. 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.
- **Real property straddling a qualified OZ.** If the amount of real property based on square footage located within the qualified OZ is substantial as compared to the amount of real property based on square footage outside of the qualified OZ, and the real property outside of the qualified OZ is contiguous to part or all of the real property located inside the qualified OZ, then all of the property is deemed to be located within a qualified OZ.

Corporations

- **Consolidated group rules.** The proposed regulations do not allow capital gains of one member of a consolidated return group of corporations to be treated as capital gain of other members of the consolidated return group. As such, gains may not be aggregated under a single deferral election by the consolidated return group for purposes of the OZ statute. Rather, each corporation in a consolidated group must separately invest in a QOF.

Also, a QOF C corporation can be the common parent of a consolidated group, but it cannot be a subsidiary member of a consolidated group.

The proposed regulations provide, in short, the same member of the consolidated group must: (i) sell a capital asset to an unrelated person, the gain of which the member elects to be deferred; and (ii) invest an amount of such deferred gain from the original sale into a QOF.

Open Items

As with any regulatory guidance, many areas remain open. Most notably:

- **Interim gains at fund level.** In the first tranche of guidance, Treasury asked whether interim gains should be subject to tax. Treasury still has expressed a concern it they may not have the regulatory authority to rule such gains are not subject to current taxation.
- **Reporting requirements.** This round of regulations doesn't impose reporting requirements that would allow the IRS to assess penalties on those who violate the rule. The Treasury Department [released a document today](#) soliciting public input on how to best measure economic activity in opportunity zones and how to collect this this information.

Treasury said that within a few months of the publication of these proposed regulations, the Treasury Department and the IRS expect to address the administrative rules applicable to a QOF that fails to maintain the required 90 percent investment standard, as well as information-reporting requirements.

In addition, the Treasury Department and the IRS anticipate revising the form for tax years 2019 and following. It is expected that proposed revisions to the Form 8996 could require additional information such as (1) the employer identification number (EIN) of the qualified OZ businesses owned by a QOF and (2) the amount invested by QOFs and qualified OZ businesses located in particular Census tracts designated as qualified OZ.

While today's guidance answers some important questions, there are still significant unanswered questions and areas that need additional guidance or clarification. Treasury is expected to continue to issue guidance and many of these items will likely be included.

Next Steps

This guidance merits-and will receive-significantly more examination and will require follow-up guidance and clarification from Treasury and the IRS. As mentioned earlier, Treasury announced that it would accept comments on the proposed guidance for 60 days, so stakeholders should weigh in, particularly on some issues that may need addressing. The [OZ Working Group](#) will certainly be doing so. A public hearing is scheduled for July 9, 2019, at 10 a.m. The public hearing will be held at the New Carrollton Federal Building at 5000 Ellin Road in Lanham, Maryland 20706.

Many of the rules adopted in the proposed regulations and guidance are consistent with the consensus recommendations of the [OZ Working Group](#). In the weeks and months ahead, the OZ Working Group will focus its attention on responding to the areas that Treasury has requested comments, comment on the proposed regulations and other guidance as released, and develop recommended practices for implementing portions of the regulations and guidance.

The good news is that the guidance is here. Now comes the heavy lifting of applying it and helping improve communities.

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