

Qualified Opportunity Zones: New Proposed Regulations Provide Further Guidance

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The Treasury Department has now released a second round of proposed regulations on the Qualified Opportunity Zone ("QOZ") provisions under Internal Revenue Code Section 1400Z-2.

Real estate developers, fund sponsors, and property owners have been awaiting further guidance on the new Qualified Opportunity Zone ("QOZ") provisions included in last December's Tax Cuts and Jobs Act, since the IRS issued an initial set of proposed regulations on Friday, October 19, 2018. Our advisory regarding those initial proposed QOZ regulations can be found [here](#). The newly released proposed regulations, issued April 17, 2019, address various issues raised or unaddressed by the initial proposed regulations.

While the QOZ rules generally will be effective only after they are issued as final regulations, taxpayers may rely on the proposed regulations, with certain exceptions, in the meantime, so long as they rely on the rules in their entirety and in a consistent manner. Of particular note, the proposed rules related to the gains eligible for exclusion after the required 10 year holding period may not be relied on until the regulations are final. Also, a taxpayer cannot rely on the proposed rules allowing unimproved land to qualify as QOZ business property if the QOF or the QOZ business intends not to improve the land by more than an "insubstantial amount" within 30 months after the date of purchase. It is uncertain what constitutes an "insubstantial amount" for this purpose.

Key guidance in the new proposed regulations provides increased flexibility regarding the disposition of either interests or underlying property in QOFs held for more than 10 years for purposes of excluding gain, exclusion of cash investments received in the last 6 months when applying the 90% asset test, and inclusion of leased property among qualifying QOZ property (and exclusion thereof from the original use requirements).

These and other salient topics addressed in the new proposed regulations include:

1. **Qualifying Property**

- *Definition of "Substantially All"*. The term "substantially all" appears in multiple instances in section 1400Z-2. The prior regulations clarified that for purposes of the requirement in the definition of qualified opportunity zone business that substantially all of the assets of the business be qualified opportunity zone business property, "substantially" all means 70%. The new regulations address the other uses of "substantially all" in section 1400Z-2. Property may qualify as QOZ business property only if during *substantially all* of the QOF's holding period for such property, *substantially all* of the use of such property has been in a qualified

opportunity zone. The regulations clarify that substantially all of the *use* of QOZ business property means 70% (regardless of whether the tangible property is owned or leased), and “substantially all” of the *holding period* means 90%.

- *Active Trade or Business Requirement.* The proposed regulations clarify that the activity of ownership and operation - including leasing - of real property qualifies as an active trade or business. Merely entering into a triple net lease with a tenant does not qualify, however.
- *Relief for Newly Contributed Assets.* A QOF does not need to take into account any property received as a contribution to equity in the six months immediately preceding a testing date to determine whether it satisfies the 90% asset test, as long as those contributions are held in cash, cash equivalents, or debt instruments with terms of 18 months or less.
- *Vacant Land and Other Property.* Vacant land is not required to meet the original use requirement, nor is there a requirement to spend any minimum amount on a substantial improvement of the land in order for it to be a qualifying asset. Note, however, that the land is required to be used in an active trade or business and, as noted above, a triple net lease of the land to a tenant would not so qualify under the proposed regulations. A building or other structure that has been vacant for at least five years prior to being purchased by a QOF or QOZ business will satisfy the original use requirement.
- *Real Property Straddling QOZ Census Tracts.* For property that is both within and without an opportunity zone, the proposed regulations provide that in order to meet the requirements of section 1400Z-2, the property located within the zone must be substantial as compared to the property located outside of the zone. For these purposes, property in the zone should be considered to be substantial if the unadjusted cost of the real property in the zone is more than the unadjusted cost of the real property outside of the zone.

1. **Eligible Gain**

- *Section 1231 Gains.* The proposed regulations provide that in the case of section 1231 gains (including gains from the sale or exchange of real property used in a trade or business), only 1231 gain that constitutes capital gain net income is eligible for deferral. The 180-day period for reinvesting such gain into a QOF begins on the last day of the taxable year, once the amount of net gain is determinable. It appears that limiting deferrable 1231 gain to only net gain – rather than all 1231 gain – may have resulted from a misunderstanding of comments to the effect that because net capital gains cannot be computed until year-end, the 180 day reinvestment period should begin at year-end (so that the 180 days could not lapse in whole or in part prior to an investor's ability to determine net capital gains and make informed decisions about what to reinvest). Those comments likely did not mean to imply, however, that the regulations should both start the 180-day period at year end *and* limit qualified gains to net gains only.
- *Carried Interests.* The proposed regulations provide that an interest issued by a QOF in exchange for services (i.e., a “carried interest” or “promote”) is not eligible for the gain exclusion rules. It appears that where a service provider contributes capital in exchange for an equity interest that includes a disproportionate participation in gain, the interest will have

to be bifurcated between the portion acquired for capital and the portion acquired for services.

- *Acquisition of QOF Interest from Current Investors.* The proposed regulations provide that if a taxpayer acquires an eligible interest in a QOF from another investor, rather than directly from the QOF, the amount of the taxpayer's qualifying investment is equal to the cash or fair market value of the property (as determined immediately before the exchange) that is exchanged for the QOF interest.

1. **Fund/Property Dispositions**

- *Sales of QOF Interests or Property.* The proposed regulations permit an investor in a QOF to benefit from the gain exclusion rule for investments held for more than 10 years without regard to whether the investor disposes of its interest in the QOF or whether the QOF itself sells the underlying property. The flexibility to hold and sell either interests or property for purposes of gain exclusion facilitates the formation of multi-asset QOZ investment funds, without the need to use a separate investment partnership for each property in the fund's portfolio. There is some ambiguity around whether this rule applies where a lower-tier QOZ business sells the asset and recognizes the gain rather than the QOF itself.
- *Reinvestment of QOF Proceeds.* If a QOF reinvests proceeds within 12 months from sale or disposition of QOZ business property, QOZ stock, or QOZ partnership interests, those proceeds are treated as QOZ property for purposes of the 90% asset test, so long as they are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. The proceeds are not required to be reinvested in an identical type of qualifying investment as the sold investment (e.g., QOZ stock proceeds could be reinvested in QOZ business property). Further, the proposed regulations provide relief if there is delay beyond the 12-month period caused by government action, application for which is complete. It should be noted, however, that although the regulations provide additional flexibility with respect to the qualifying property threshold, they do not provide for a deferral of gain related to the reinvested proceeds.
- *Dispositions and Distributions.* Under the proposed regulations, with limited exceptions (including an exception for certain transfers upon death discussed below), any disposition of an interest in a QOF (including by way of gift) accelerates the gain deferred on the investment in the QOF.
- *Distributions.* Distributions from a QOF may be treated as dispositions in certain cases. A distribution from a QOF partnership that does not exceed the investor's basis in their interest generally does not result in gain, however. The proposed regulations clarify that an investor's basis for this purpose includes any basis resulting from indebtedness of the QOF that is allocated to the investor under Code Section 752. Thus, debt-financed distributions may be permissible.
- *Exempt REIT Capital Gain Dividends.* The proposed regulations allow QOF REITs to designate special capital gain dividends that do not exceed the QOF REIT's long-term gains on sales of QOZ property. If QOF REIT shares are qualified investments in the hands of some of its

shareholders, those dividends are tax-free to the shareholders who could have elected a basis increase in the case of a sale of the QOF REIT shares. If on the identified date for the dividend, the shareholder held its qualifying investment in the QOF REIT for 10 years or more, the dividend may be tax-free.

1. Leased Property

- *Leased Property Allowed as Qualifying Asset.* Property leased under a market rate lease entered into after December 31, 2017 can be a qualifying asset, and such property is not subject to the original use or substantial improvement requirements. Certain additional requirements apply in the case of property leased from a related party, including a prohibition against significant pre-payments of rent (defined as a prepayment of rent for a period exceeding 12 months), and in the case of personal property, a requirement that the lessee acquire other tangible property with a value at least equal to that of the leased property.
- *Improvements to Leased Property.* Improvements made by a lessee to leased property (e.g., a building constructed on leased land) are treated as purchased property that satisfy the original use requirement. The treatments of improvements to leased property taken with the preceding rule regarding leased property itself should enable existing owners and lessees of property in a QOZ to potentially benefit from the QOZ rules.
- *Valuation of Leased Property.* Leased tangible property must be valued annually, using either a financial statement valuation method (using the value of the property as reported on the applicable financial statements) or an alternative valuation method (using the sum of the present values of the payments to be made under the lease, determined at the time of entry into the lease). Once a method is chosen, the QOF or QOZ business must apply it consistently to all leased property for the taxable year. The leased property value is used for all testing dates for the “substantially all of the use” requirement (discussed above) and the requirement that 90% of the assets be invested in QOZ property.

1. Guidance for Non-Real Estate Businesses.

- *50% Income Test.* The proposed regulations provide guidance, including three alternative safe harbors, for how non-real estate businesses such as potential tenants in a QOZ can meet the requirement that 50% of their income be derived in the QOZ. The tests focus on the location of the services being performed by employees or other service providers (based on hours), the location of the services being performed by employees or other service providers (based on amounts paid), and the location of tangible property coupled with the location of the businesses management or operational functions. Taxpayers who do not satisfy one of the three safe harbors may still meet the 50% requirement based on facts and circumstances. The regulations notably do not appear to contain any requirement that customers of a business be located in the QOZ.
- *Working Capital Safe Harbor.* The proposed regulations provide that the safe harbor written designation for planned use of working capital includes development of a trade or business in the QOZ, as well as acquisition, construction and substantial improvement of tangible

property. Further, a delay beyond the 31-month period caused by awaiting government action will not cause violation of the safe harbor, so long as the application for that government action was completed during the 31-month period.

1. Relief for Estate Planning

The proposed regulations provide that a QOZ investment may be transferred to a grantor trust without triggering an inclusion of the deferred gain. Further, if a QOZ investment is held by a grantor trust, the death of the grantor is not considered an inclusion event under the new guidance. Finally, the new rules clarify that upon the death of a taxpayer holding a QOZ investment, the deferred gain is not triggered when the investment is distributed to a beneficiary by the estate of the taxpayer, and that such beneficiary steps into the shoes of the decedent for purposes of determining the holding period of the QOZ investment.

1. Anti-Abuse Rule.

If a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of the QOZ rules, the IRS can recast a transaction (or series) for federal tax purposes to achieve results consistent with the purposes of section 1400Z-2. The test for whether a tax result is inconsistent with the QOZ purposes is one of facts and circumstances.

For additional information, please contact any member of our [Tax Group](#).

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