

Practice Update

Treasury Releases Second Round of Proposed Opportunity Zone Regulations

April 22, 2019

The Treasury Department released the second round of proposed regulations under the Qualified Opportunity Zone program (the “New Regulations”) on [April 17, 2019](#). These New Regulations make additions to, and in some cases replace portions of, the first round of proposed regulations released in October 2018.

The New Regulations address several key areas, including definitions of substantially all, original use, and active trade or business, as well as the treatment of land, the treatment of leases, the timing rules for Section 1231 gains, the sourcing of gross income for a qualified opportunity zone business (QOZB), and the reasonable period for a qualified opportunity fund (QOF) to reinvest proceeds from the sale of qualifying assets without incurring a penalty. Notably, the New Regulations contain taxpayer-friendly rules which allow QOF investors more flexibility when exiting their QOF investments after a 10-year holding period. In addition, the New Regulations generally allow for QOF partnerships to make debt-financed distributions to partners on a tax-free basis in certain cases.

Treasury also stated that within a few months of the publication of the New Regulations, they expect to address the administrative rules applicable to a QOF that fails to maintain the required 90 percent investment standard. Treasury noted that they plan

Related People

Steven P. Polivy
Beth Zafonte

Related Work

Qualified Opportunity
Zones
Real Estate
Tax

Related Offices

Miami
New York

to propose revisions to IRS Form 8996 (Qualified Opportunity Fund) which could require the reporting of additional information such as the employer identification number of the QOZB owned by a QOF as well as the amount invested by QOFs and QOZBs located in particular qualified opportunity zones.

A general overview of the New Regulations is provided below.

Definition of “Substantially All”

A QOZB must operate a trade or business in which “substantially all” of the tangible property owned or leased is qualified opportunity zone business property (“QOZBP”). The 2018 Regulations clarified that for purposes of this requirement, the threshold to determine whether a trade or business satisfies the “substantially all” test is 70 percent. However, the term “substantially all” is also used elsewhere in the statute in different contexts. The New Regulations state that there will be a 90% threshold when “substantially all” refers to a holding period, but a 70% threshold for “substantially all” when used in the context of the use of property.

“Original Use” and Land

The New Regulations provide that the “original use” of tangible property acquired by purchase commences on the date when a person (or a prior person) first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization. Accordingly, tangible property located in a qualified opportunity zone that is depreciated or amortized by a person other than the QOF or QOZB would not satisfy the original use requirement. Both new and used property can qualify under the original use test (provided such property has not been previously depreciated or amortized during use in a qualified opportunity zone). Tangible property, including buildings or other structures, which have been unused or vacant for at least five continuous years prior to being

purchased by a QOF or QOZB, can meet the original use requirement.

Land is not required to meet the substantial improvement test and cannot meet the original use test. Under the New Regulations, land can be treated as QOZBP only if it is used in a trade or business of a QOF or QOZB. Trade or business is defined by reference to Code Section 162 principles. An anti-abuse rule seeks to prevent inappropriate “land banking.”

Active Conduct of a Trade or Business Requirement for a QOZB

A trade or business will be measured by reference to Code Section 162 principles. Notably, the New 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 is not the active conduct of a trade or business.

Safe Harbor for Inventory in Transit

The New Regulations provide that inventory (including raw materials) will not be considered to fail to be used in a qualified opportunity zone solely because the inventory is in transit from a vendor to a facility of the trade or business that is in a qualified opportunity zone, or from a facility of the trade or business that is in a qualified opportunity zone to customers of the trade or business that are not located in a qualified opportunity zone.

Leases

The New Regulations provide that for purposes of the 90% QOF test and the 70% QOZB test, leased tangible property meeting the following criteria may be treated as QOZBP: (1) the leased tangible property must be acquired under a lease entered into after December 31, 2017, and (2) substantially all of the use of the leased tangible property must be in a qualified

opportunity zone during substantially all of the period for which the business leases the property.

The New Regulations do not require leased tangible property to be acquired from a lessor that is unrelated, however, if a QOF or QOZB enters into a related party lease, then the leased property will not be treated as QOZBP if (1) in connection with the lease, a QOF or QOZB at any time makes a prepayment to the lessor relating to a period of use of the leased tangible property that exceeds 12 months, or (2) in certain cases, the lessee fails to acquire tangible property that is QOZBP that has a value not less than the value of the leased personal property within a certain time period.

All leases must be “market rate leases.” For this purpose, whether a lease is market rate is determined under the transfer pricing principles under Code Section 482.

The New Regulations also provide an anti-abuse rule in the case of leased real property (other than unimproved land).

Real Property Straddling a QOZ

The New Regulations provide guidance on how a QOZB which owns real property which straddles a qualified opportunity zone may apply the various QOZB tests. In general, if the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property would be deemed to be located within a qualified opportunity zone for purposes of applying the QOZB tests.

50% Gross Income Test for a QOZB

Under the 2018 Regulations, a QOZB must derive at least 50 percent of its total gross income from the active conduct of a business within a qualified opportunity zone. The New Regulations provide three safe harbors and a facts and circumstances test for determining whether the requisite income is derived from a trade or business in a qualified opportunity zone for purposes of the 50 percent gross income test. A QOZB only needs to meet one of the safe harbors or the facts and circumstances test in order to satisfy the 50 percent gross income test.

The first safe harbor is met if at least 50 percent of the services performed (based on hours) for the QOZB by its employees and independent contractors (and employees of independent contractors) are performed within the qualified opportunity zone.

The second safe harbor is met if at least 50 percent of the services performed for the QOZB by its employees and independent contractors (and employees of independent contractors) are performed in the qualified opportunity zone (based on amounts paid for the services performed).

The third safe harbor is met if the tangible property of the QOZB that is located in a qualified opportunity zone and the management or operational functions performed for the QOZB in the qualified opportunity zone are each necessary to generate 50 percent of the gross income of the trade or business.

Finally, QOZBs not meeting any of the safe harbor tests may satisfy the 50 percent gross income 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 opportunity zone.

Intangible Property Requirement for a QOZB

The New Regulations provide that for purposes of determining whether a substantial portion of intangible property of a QOZB is used in the active

conduct of a trade or business, the term substantial portion means at least 40 percent.

Modification to the Working Capital Safe Harbor for a QOZB

Under the New Regulations, the working capital safe harbor was revised to permit the written statement to include the development of a trade or business in the qualified opportunity zone as well as acquisition, construction, and/or substantial improvement of tangible property. In addition, a QOZB does not violate the safe harbor if the 31-month period is not met provided that the delay is attributable to waiting for government action the application for which is completed during the 31-month period.

Section 1231 Gain

The New Regulations provide that the 180-day period for investing capital gain income from section 1231 property in a QOF begins on the last day of the investor's taxable year because technically the capital gain income from section 1231 property is determinable only as of the last day of the taxable year.

Relief for Investments under the 90% Test

The New Regulations allow a QOF to apply the 90% asset test without taking into account any investments received in the preceding 6 months to the extent the investment is held in cash, cash equivalents, or debt instruments with term of 18 months or less.

Reasonable Reinvestment Period

The New Regulations provide that proceeds received by a QOF from the sale or disposition of QOZBP, qualified opportunity zone stock, or qualified opportunity zone partnership interests are treated as qualified opportunity zone property for purposes of the QOF's 90% asset test only if the QOF reinvests the proceeds received during the 12-month period beginning on the date of such distribution, sale, or

disposition into other qualifying property and provided that in the interim, the proceeds are continuously held in cash, cash equivalents, and debt instruments with a term of 18 months or less. This rule currently only applies to a QOF, and not to a QOZB. There is relief from failure to meet the 12-month requirement to the extent attributable to delay in government action.

The Preamble to the New Regulations states that while a sale of property and/or reinvestment by a QOF does not impact an investor's holding period in the QOF or otherwise trigger the recognition of any deferred gain, any gain recognized on the sale of the property by the QOF will generally still be taxable to the applicable investor, subject to the special rules discussed elsewhere in the New Regulations pertaining to the ability to elect to exclude certain gain after a 10-year holding period of QOF equity.

Contributions of Property to a QOF

The New Regulations propose technical rules for determining the eligibility of contributions of property in kind to a QOF.

Recognition Events for QOF Equity Dispositions and Distributions

Events that would trigger a disposition of QOF equity include sales or gifts of QOF equity, distributions in excess of QOF equity basis, and certain other reorganization transactions that would otherwise traditionally be nonrecognition transactions for income tax purposes.

QOF Interests Received For Services – Carried Interests

QOF interests received by an investor in exchange for services (such as a carried interest in a QOF partnership issued to a partner in exchange for services) are not eligible for any of the special tax benefits under the QOZ program.

Basis in the QOF and 10-Year Step-Up

After a 10-year holding period, an investor's fair market value basis adjustment election is deemed to be made immediately prior to the sale or exchange, and, in the case of a QOF partnership, also results in an adjustment to the basis of the underlying assets under Code Section 743(b)-type principles, which could have the effect of eliminating any Code Section 751 inclusion at such time. The fair market value of a QOF partnership interest is determined by taking into account partnership debt.

Further clarifications are made concerning an investor's basis in a QOF partnership.

Special Election for Partnership and S Corporation Property Dispositions

After an investor in a QOF partnership or S corporation meets the 10-year holding period, the investor is eligible to make an election to exclude from gross income some or all of the capital gain from the QOF's disposition of qualified opportunity zone property that would normally be reported on Schedule K-1 to the partner or shareholder, provided the disposition by the QOF occurs after the investor's 10-year holding period has elapsed.

QOF REIT Rules

QOF REITs are eligible in certain cases to pay tax-free capital gain dividends to shareholders provided the REIT shareholder has held the shares for at least 10 years.

Gifts and Bequests

A gift of QOF equity is generally a disposition of the QOF interest, which would be a triggering event for inclusion of the deferred gain. However, a transfer to a grantor trust is not a disposition for this purpose, nor are certain transfers as a result of an investor's death.

Consolidated Return Rules

The New Regulations provide guidance about the application of the consolidated group rules to QOFs. In general, a C corporation QOF can be the common parent of a consolidated group, but it cannot be a subsidiary member of a consolidated group.

Holding Period

A QOF investor's holding period generally begins on the date the QOF equity is acquired. Thus, a QOF investor's holding period in QOF equity does not include the period during which the QOF investor held property that was transferred in-kind to the QOF in exchange for the equity. Also, if an investor disposes of its entire QOF equity and reinvests in a second QOF within 180 days, the investor's holding period for its investment in the second QOF begins on the date of the second investment. Special rules apply for certain corporate reorganization transactions.

General Anti-Abuse Rule

The New Regulations provide that if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of the QOZ program, the IRS can recast the transaction for tax purposes as appropriate to achieve tax results that are consistent with the purposes of the QOZ program.

This Akerman Practice Update is intended to inform firm clients and friends about legal developments, including recent decisions of various courts and administrative bodies. Nothing in this Practice Update should be construed as legal advice or a legal opinion, and readers should not act upon the information contained in this Practice Update without seeking the advice of legal counsel. Prior

results do not guarantee a similar outcome.