TAX CLIENT ALERT

Qualified Opportunity Zones: Second Set of Proposed Treasury Regulations

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In mid-April, the much anticipated second set of Proposed Treasury Regulations under the Qualified Opportunity Zone ("QOZ") tax incentive program were released. Although the program has been promising from its inception, the Internal Revenue Code ("Code") provisions setting up the program, along with the first set of Proposed Treasury Regulations under the program which were released in October 2018, left many unanswered questions. This stalled investors and developers from moving forward with projects the program was designed to encourage. We believe that this second set of Proposed Treasury Regulations is both taxpayer-friendly and should provide enough answers to get many, if not all, of these projects off the ground.

For those unfamiliar with the program, we provide an overview below. Following this overview, we provide insight about the recently issued second set of Proposed Treasury Regulations.

Qualified Opportunity Zones: Overview

The QOZ tax incentive program was enacted as part of the Tax Cuts and Jobs Act at the end of 2017 in an effort to encourage long-term investment in low-income communities, or QOZs. QOZs are low-income census tracts meeting certain criteria that were designated by local officials and certified by the Treasury Department as satisfying the criteria. The final list of QOZs has been in place since early 2018 and is unchanging. There are more than 8,700 QOZs across the country.

The QOZ program provides three distinct tax benefits to those willing to invest in a QOZ.

1. An investor is allowed to defer paying tax on recognized capital gain from the sale of an asset to an unrelated person by investing that capital gain in a QOZ, and the deferral continues until the earlier of the date the investment is sold or December 31, 2026.

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2. If the investor holds the QOZ investment for a sufficient time prior to the end of the deferral period, the amount of deferred gain is reduced—along with the corresponding tax liability on the deferred gain—by up to 15%.
3. If the investor holds the QOZ investment for at least 10 years, the investor may elect to pay no tax on any post-acquisition gain on the QOZ investment when it is ultimately sold.

To qualify for these tax benefits under the program, within 180 days of an event triggering the recognition of capital gain (with an extended period available for owners of pass-through entities recognizing the gain), the investor must invest in a Qualified Opportunity Fund ("QOF"), which is an investment vehicle structured as a corporation or tax partnership for the purpose of investing in QOZs. The QOF is required to hold 90% or more of its assets in Qualified Opportunity Zone Property ("QOZP"; the 90% test referred to as the "90% Test"). The 90% Test is measured by averaging the QOF's asset makeup: (i) six months into its tax year, and (ii) at the end of its tax year. If a QOF fails the 90% Test, the QOF is required to pay a monthly penalty, with the penalty subject to a reasonable cause defense. For purposes of measuring the 90% Test, the QOF uses either values listed on its applicable financial statement (audited GAAP statements or SEC filings, if required), or asset cost.

QOZP, in turn, is either (i) Qualified Opportunity Zone Business Property ("QOZBP"), or (ii) stock or partnership interests in a Qualified Opportunity Zone Business ("QOZB"). To qualify as QOZBP, property must be acquired by the QOF or QOZB from an unrelated party (using a 20% common ownership relatedness test) after December 31, 2017, and either (a) the property's original use in the QOZ must start with the QOF or QOZB, or (b) the QOF or QOZB must substantially improve the property. To constitute substantial improvement, over a 30-month period, the QOF or QOZB is required to make improvement expenditures for the property by more than its cost basis in the property. However, if land and improvements in a QOZ are acquired, the QOF or QOZB can exclude the value of the land for purposes of calculating the amount that must be spent to substantially improve the acquired property. Finally, during "substantially all" of the QOF or QOZB's holding period of the property, "substantially all" of the use of the property must be in a QOZ.

To qualify as QOZB stock or partnership interests, the QOF must acquire the stock or partnership interests after December 31, 2017, directly from the corporation or partnership, for cash, and the corporation or partnership must satisfy several other requirements for "substantially all" of the QOF's holding period of the stock or partnership interests, including:

- "Substantially all" (defined by the first set of Proposed Treasury Regulations as at least 70%) of the QOZB's assets must be QOZBP (the "70% Test").
- For each year:
    - At least 50% of the QOZB's income must be derived from the active conduct of a trade or business in a QOZ.
    - A substantial portion of the QOZB's intangibles must be used in the active conduct of a trade or business in a QOZ.
    - Less than 5% of the QOZB's property can be nonqualified financial property, with a carveout for reasonable working capital held in cash, cash equivalents, or short-term debt instruments.
        - The first set of Proposed Treasury Regulations created a safeharbor for reasonable working capital. This safeharbor allows a QOZB to hold an unlimited amount of working capital without impact to its qualification as a

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QOZB if it has a written schedule consistent with the ordinary startup of a trade or business for expenditure of its working capital assets within 31 months of its receipt of assets, and the working capital is actually used in manner that is substantially consistent with the written plan.

- The QOZB cannot be engaged in certain businesses, including a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, and any store, the principal business of which is the sale of alcoholic beverages for consumption off premises.

The first set of Proposed Treasury Regulations established several important pieces to the program, including setting up the 70% Test for QOZBs, and also establishing the working capital safeharbor for QOZBs. These features of the first set of Proposed Treasury Regulations have influenced many projects to structure as indirect investment by a QOF through a QOZB subsidiary. While this guidance was helpful, it did not address many features of the program investors and developers were interested in. The Treasury Department appears to have reviewed and addressed most of the comments it received about the program in the second set of Proposed Treasury Regulations. Below is a selection of items addressed in this important guidance.

Highlights of the Second Set of Proposed Treasury Regulations

QOF Asset Churning and New Capital

For purposes of the 90% Test, QOFs are provided 12 months to reinvest proceeds from sale of QOZBP (or returns from QOZBs), as long as the proceeds are held in cash or short-term debt during this period. In other words, the cash resulting from the sales or returns will not count against the QOF for purposes of the 90% Test during this period and do not impact an investor's holding period for purposes of the QOZ tax benefits.

Unless further relief is provided in future guidance, the sale of assets will not trigger deferred gain to investors, but any gain will be passed through and picked up by investors in QOFs structured as pass-through entities.

Also, new capital received by a QOF during the 6-month period prior to a testing date may be excluded from the 90% Test, as long as the capital is held in cash or short-term debt until deployed.

Exit strategy relief

When QOFs structured as tax partnerships or S corporations sell their QOZP assets, a partner or shareholder who has held its interest in the QOF for 10 years at that time may elect to exclude capital gain that is allocated to them from the sale. This is welcomed, but it will often still be better for the investor to exit by selling their equity interest in the QOF. Exiting by equity sale after holding the investment for 10 years results in no tax on any gain recognized on the investment, whereas an asset sale can trigger income that is not taxed as capital gain, and the regulations provide no protection from recognition and tax on this non-capital gain income resulting from an asset sale by the QOF. Further, this relief currently only applies to sales by QOFs and does not extend to asset sales by QOZBs.

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"Active Trade or Business" Requirement for QOZBs
For purposes of the requirement that 50% or more of a QOZB's income be derived from an "active trade or business," a QOZB must conduct a Code § 162 trade or business. This generally requires an activity that is engaged in with continuity, regularity, and for profit. This standard has often been problematic for rental real estate businesses, but the regulations specify that the ownership and operation (including leasing) of real property is generally considered the active conduct of trade or business under the program. Notwithstanding, leasing property on a triple net basis is not the active conduct of trade or business under the program, so QOZBs will need to be thoughtful with how they operate real estate businesses.

Substantial improvement/original use requirements for QOZBP
Raw land purchased by a QOF or QOZB does not need to be substantially improved but must be used in the entity's Code § 162 trade or business.

Original use in a QOZ begins when any person first places the property in service in the QOZ for purposes of depreciation. This means that turn-key purchases without further improvement by the QOF or QOZB are an option where the purchased real estate has not been placed in service in the QOZ.

In addition, if a building has been vacant for 5 years or more, the original use period starts fresh, meaning the purchase of such a building in a QOZ can qualify as original use, and no substantial improvements would be required to that building.

Finally, substantial improvement must be measured on an asset-by-asset basis. Without careful planning, this could be problematic for multi-asset acquisitions. Hopefully, the IRS will reverse course on this rule in future guidance.

"Sale or exchange" for purposes of the end of the deferral period
The regulations include a lengthy, nonexclusive list of "inclusion events" for purposes of determining when an investor's deferral period ends (recall that it ends on the earlier of the date of the sale of the investment, or December 31, 2026). Generally, any reduction in equity ownership interest in the QOF is considered a sale ending deferral under the regulations. This includes gifting interests to others. However, death is not an inclusion event. Certain changes to the ownership of an entity that invests in a QOF are also inclusion events.

Debt-financed distributions from QOF Partnerships
For QOFs taxed as partnerships, debt-financed distributions are generally allowable as long as the distributions do not exceed an investor's tax basis. If they exceed an investor's tax basis, this will trigger an inclusion event to the extent the distributed amount exceeds the investor's basis on a dollar for dollar basis. Moreover, the regulations reference the disguised sale rules applicable to tax partnerships, which effectively mean that distributions from a tax partnership QOF within two years of investment may be problematic.

Leased Property
A QOF or QOZB may lease property and have it constitute QOZBP. Several rules have been put in place for leased property, including heightened requirements for leases between related parties (although related party leasing is permitted). This provides even more flexibility for business structuring, and may prove useful depending upon the particular situation.

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Asset Valuation
The QOF or QOZB may choose which valuation method to use annually for purposes of the 90% Test/70% Test (applicable financial statement vs. cost) and there is no consistency requirement from year to year.

Anti-Abuse Rule
The regulations contain a new anti-abuse rule that permits the IRS to recast transactions as necessary to achieve the goals of the QOZ program. This is all based on facts and circumstances and left to the discretion of the IRS. For many, this will be enough to ensure structuring projects to fit squarely within the program and not push the envelope too much.

The Qualified Opportunity Zone tax incentive program has been promising since its inception, but with the addition of the second set of Proposed Treasury Regulations, many projects should be able to move forward without issue.

If you would like to discuss potential opportunities with the program, please contact James Scears or your GableGotwals attorney.

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