The cloud lifts – the Oz Regs 2.0 are out

US Tax Alert

19 APR 2019
By: Stephen M. Sharkey | Darryl Steinhouse

On April 17, 2019, the Department of Treasury/Internal Revenue Service issued this should be “their” – Treasury and IRS [_____] two separate agencies its second set of proposed regulations (the OZ Regs 2.0) under the Opportunity Zone provisions of the Internal Revenue Code of 1986 (the Code). With the issuance of the OZ Regs 2.0, released about 6 months after the first set of proposed regulations (the October 2018 OZ Regs), it appears that the cloud of uncertainty that has been hanging over the Opportunity Zone program has lifted – and that the program is finally poised to live up to its promise.

While lawyers and accountants will be poring over the 169 pages of OZ Regs 2.0 for quite some time, their main thrust is clear: the Trump Administration has thrown its full weight behind delivering taxpayer favorable rules and guidance to promote the success of the Opportunity Zone program.

Although the OZ Regs 2.0 were issued in proposed form, they may generally, like the October 2018 OZ Regs, be relied on by taxpayers and QOFs currently.

The following are our initial observations on the OZ Regs 2.0.

HIGH POINTS – SLAYING THE OZ DRAGONS

1. **Operating businesses as QOZBs.** Prior to the OZ Regs 2.0, there was virtually no guidance on when – except in the simplest cases – a Qualified Opportunity Fund (QOF) could invest in an operating business –
that is, what it would take for an operating business to satisfy the tests to be a Qualified Opportunity Zone Business (QOZB). The Treasury/IRS read the statute to require a QOZB derive more than 50 percent of its gross income from the "active conduct of a business within a Qualified Opportunity Zone" – but there were no rules for determining (i) what is "active conduct" or (ii) where income is deemed to be earned (inside or outside an Opportunity Zone).

In a major development under the OZ Program, the OZ Regs 2.0 provide extraordinarily helpful safe harbors for a business entity to satisfy the 50 percent active gross income test to be considered a QOZB. Under the safe harbors, a QOZB will be deemed to satisfy the 50 percent active gross income test if (i) more than 50 percent of the services performed for the business (measured either by number of hours or by amounts paid) by its employees and independent contractors are performed within the Opportunity Zone or (ii) both tangible property and management/operations that are necessary to generate 50 percent of the gross income of the QOZB are situated in an Opportunity Zone. A business that does not satisfy these safe harbors may meet the 50 percent active gross income test based on all of the facts and circumstances.

- An illustrative example in the OZ Regs 2.0 closely resembles a "Google" type tech company. It involves a startup business that develops software applications for global sale in a campus located in an Opportunity Zone. In the example, a majority of the total hours of the startup’s employees and contractors developing software applications are located in the Opportunity Zone. The startup business satisfies the 50 percent active business income test even though the business makes the vast majority of its sales to consumers located outside of the Opportunity Zone where its campus is located.

- Another example in the OZ Regs 2.0 involves a landscaper whose officers and employees manage the daily operations of its business from headquarters located in an Opportunity Zone. The business performs services for customers both inside and outside the Opportunity Zone, but all of its equipment and supplies are stored at the business headquarters. Since the business’ management activity and equipment and supplies reside within the Opportunity Zone, they are deemed necessary to generate 50 percent of the gross income of the trade or business.

- Despite this good news, it appears startup/tech businesses may face a new hurdle under the OZ Regs 2.0. Under the statute, a QOZB must use a "substantial portion" of its intangible property in an Opportunity Zone. In what would appear to be merely a technical clarification, the OZ Regs 2.0 state that "substantial portion" means for this purpose at least 40 percent. How a software developer (or other tech company) will be able to demonstrate where it "uses" its patents, trademarks, goodwill and other intangible property – and that 40 percent of the use occurs within the Opportunity Zone where it is located – still need to be identified.

2. **Fixing the 10-Year gain elimination problem for diversified funds.** The statute contains a well-known glitch under which it would appear that, where a taxpayer (QOF Investor) makes an eligible investment in a QOF formed as a partnership (QOF Partnership), the elimination of the QOF Investor’s gain from holding his/her qualified investment (a Qualified OZ Fund Interest) after 10 years is only available if the QOZ Investor sells his/her Qualified OZ Fund Interest in the QOF Partnership. By contrast, it appeared that a QOZ Investor would be deprived of the gain elimination benefit if the QOF Partnership were instead to sell its assets after the 10-year hold period and dissolve. The OZ Regs 2.0 have mostly corrected this glitch by allowing a QOF Investor to elect to eliminate from his/her taxable income any capital gain from the sale of good assets by the QOF Partnership that are allocated to him/her after the applicable 10-year hold period.

- Note that by its terms this "fix" only applies to capital gain from the sale/disposition of good assets/Qualified Opportunity Zone Property. The fix does not apply to either (i) capital gain from sales of assets that are not good assets or (ii) ordinary income of a QOF, including "true" depreciation recapture (but not unreaptured Section 1250 gain from the sale of depreciable real estate).

3. **Borrowing by QOFs formed as partnerships.** Another area of significant uncertainty/concern that had been troubling to investors in QOF Partnerships is how debt/borrowing of a QOF Partnership will be treated. The uncertainty arose out of a rule in the statute that a QOZ Investor has a $0 basis in his/her Qualified OZ Fund Interest. In another very favorable development, the OZ Regs 2.0 clarify that (i) the $0
basis rule only applies to the deferred gain that is reinvested in the QOF Partnership and a QOF Investor is able to include his/her share of the debt of a QOF Partnership (determined under the regular partnership tax rules) in the tax basis of his/her Qualified OZ Fund Interest and (ii) a QOF Investor can receive a distribution of refinancing proceeds from a QOF Partnership without triggering deferred gain or disqualifying the investment from OZ tax benefits provided that the cash distribution is not greater than the QOF Investor’s tax basis in the Qualified OZ Fund Interest (e.g., generally, his/her share of debt).

- Under something of a “taking away with the left hand what is given by the right,” it appears that debt-financed distributions by a QOF Partnership will not get these benefits under the OZ Regs 2.0 if made within 2 years of the date the QOF Investor made his/her eligible investment.

4. Addressing the QOF deployment problem. Until the OZ Regs 2.0 were issued, QOFs have had to struggle with the issue of how long they may hold cash invested by QOF Investors before the cash needed to be used to purchase good assets. The issue arose under the 90 percent Asset Test of a QOF, under which 90 percent of a QOF’s assets must be invested in Qualified Opportunity Zone Property as of the end of each 6-month testing period. The uncertainty made capital raising difficult for QOFs because, in the worst case scenario, cash contributed by a QOF Investor near a 6-month testing date would need to be almost immediately invested by the QOF. The OZ Regs 2.0 resolve the deployment problem by permitting a QOF to hold any cash capital contribution for up to 6 months prior to its having to be invested.

A FEW DISAPPOINTMENTS / CHALLENGES

1. No rollover of gains realized by a QOF. Proponents of the Opportunity Zone program have long believed/advocated that QOFs should be able to sell their investments in Qualified Opportunity Zone Property without triggering gain to the QOF or its QOF Investors, so long as the QOF “rolled over” the gains into a new investment in Qualified Opportunity Zone Property within a reasonable time period. “No go,” said the Treasury in the preamble to the OZ Regs 2.0. Treasury felt that it did not have the statutory authority to go that far.

- As a consolation prize, however, the OZ Regs 2.0 allow a QOF to hold the cash proceeds from a sale for up to 12 months before the cash needs to be re-deployed into other good assets.

2. Profits interests. The OZ Regs 2.0 take a dim view of whether profits interests in a QOF can qualify as an “eligible interest” to which OZ tax benefits apply. A profits interest in a QOF Partnership that is issued in exchange for services will be treated as having been acquired by the partner without making a qualifying investment for the profits interest (so that the profits interest will not be a Qualified OZ Fund Interest or enjoy OZ tax benefits).

- Of course, this leaves open the question as to when a profits interest is issued “in exchange for services.”

TOPICS OF BROAD APPLICATION

1. Real estate investments. The OZ Regs 2.0 were generally kind to real estate investments.

   a. Commercial property. The OZ Regs 2.0 clarify that the ownership and operation (including leasing) of real property is an active conduct of a trade or business, and provide helpful guidance (touched on below) regarding the original use requirement. Somewhat surprisingly, however, the Treasury/IRS have concluded that merely leasing real property under a triple-net-lease is not enough activity to support OZ tax benefits. Left undefined for now is exactly what is a “triple-net-lease” (i.e., how much commercial activity by the landlord is needed for a lease not to be a triple-net-lease).

   b. Land. It was unclear, until the OZ Regs 2.0 were issued, whether (or when) undeveloped land is a good asset of a QOF/QOZB (i.e., Qualified Opportunity Zone Business Property or QOZB Property). The OZ Regs 2.0 provide the following helpful clarifications: (i) land will only be treated as qualifying property (QOZB Property) if it is used in a trade or business of a QOF/QOZB and (ii) land
is generally not required to be substantially improved. Rather than address the thorny issue of passive ownership of land for speculation ("land banking") by legislating a minimum amount of construction/ improvement that must be made, Treasury/IRS adopted an anti-abuse approach which avoids artificial lines and requires taxpayers to exercise judgment/discretion. Under these anti-avoidance rules, land will not be qualifying property if a QOF or QOZB purchases/owns unimproved or minimally improved land (i) only for investment purposes (i.e., does not use the land in a trade or business), (ii) with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase or (iii) with a significant purpose of achieving a tax result that is inconsistent with the Opportunity Zone program/provisions.

2. **Leased property.** The OZ Regs 2.0 also provide a new set of taxpayer-favorable rules on property leased by a QOF/QOZB. For leased tangible property to be a good asset, the lease must (i) have begun after 12/31/2017 and be (ii) a "market rate lease," reflecting common, arms-length market terms (consistent with regulations under section 482). Generally, the original use of leased tangible property does not need to commence with the QOF/QOZB in an Opportunity Zone, and leased tangible property does not need to be substantially improved. The value of leased property must be included in both the numerator and the denominator of the 90 percent QOF Asset Test and the QOZB 70 percent Substantially All test. Improvements made by a lessee will satisfy the original use requirement and are considered purchased property. A special rule is provided that will allow QOFs to value their leases of tangible property for these purposes.

In addition, the OZ Regs 2.0 permit property to be leased to a QOF/QOZB by a related party on if (i) rent is not be prepaid by more than 12 months and (ii) if the original use of the leased tangible personal property in an Opportunity Zone does not commence with the lessee-QOF/QOZB, the lessee-QOF/QOZB purchases other tangible property that is QOZB Property equal in value to the leased tangible personal property.

3. **Inclusion events (acceleration of deferred gain).** Under the Opportunity Zone statute, a QOF Investor's deferred gain will be accelerated upon a sale or exchange of his/her Qualified OZ Fund Interest. The OZ Regs 2.0 provide extensive guidance on what events will – and those that will not – trigger this gain acceleration/inclusion (Inclusion Events). Generally, an Inclusion Event is any transfer of a Qualified OZ Fund Interest that reduces a QOF Investor's equity interest in the QOF. Other Inclusion Events include (i) gifts of an eligible interest, (ii) a distribution by a QOF Corporation in excess of the QOF Investor's basis in QOF Stock, or a distribution by a QOZ Partnership in excess of the QOF Investor's basis in his/her QOF Partnership Interest (including Section 752 share of debt), (iii) a dissolution of the QOF or (iii) claim of worthlessness of a Qualified OZ Fund Interest. Important exclusions from inclusion trigger are:

- A transfer by reason of death to or from the deceased QOF Investor's estate or otherwise by operation of law.
- A contribution by a QOF Investor of his/her Qualified OZ Fund Interest to a partnership as a non-taxable contribution property under section 721. This exception may permit Qualified OZ Fund Interests to be aggregated into an upper-tier investment partnership.

**CLARIFICATIONS AND TECHNICAL RULES**

**Eligible investments in QOF**

1. **Investment of Section 1231 gains.** A somewhat unwelcome surprise in the OZ Regs 2.0 is that the 180 day investment period for gains from section 1231 property – including commercial real estate – begins on the last day of the taxable year. This is inconsistent with the advice of many tax advisors prior to the proposed regulations, and how most taxpayers who have made investments in QOFs have measured their 180 day investment period.

2. **Property Contributions Count as "Investment."** Another Easter egg hiding in the OZ Regs 2.0 is an acknowledgment by the Treasury/IRS that a taxpayer can make an eligible investment in a QOF by
contributing property in exchange for a Qualified OZ Fund Interest, rather than just for cash. If appreciated property (i.e., value exceeds its adjusted tax basis) is contributed to a QOF, only the portion attributable to the adjusted tax basis will be treated as an eligible investment, and the balance will be a non-qualifying investment (that does not enjoy the OZ tax benefits).

- NOTE THAT this is something of an attractive nuisance. While a QOF Investor may acquire a Qualified OZ Fund Interest by contributing property, the contributed property will not be a good asset for OZ purposes (QOZB Property must be acquired by purchase).

3. **Sale of property for eligible interest.** The OZ Regs 2.0 expressly acknowledge that a property owner may transfer property to a QOF in a fully taxable transaction in exchange for an eligible interest in the QOF. The gain on the sale/exchange, however, is not eligible for deferral.

4. **Secondary purchase of existing qualified OZ Fund interest.** Surprisingly, the OZ Regs 2.0 permit a QOF Investor to make an eligible investment in a QOF by purchasing an ownership interest from an existing QOF Investor. In this case, the purchaser's eligible investment (i.e., the deferred realized gain) is the amount paid for the eligible interest. This should make holding a Qualified OZ Fund Interests more marketable/valuable.

**90 percent Asset Test**

5. **Relaxation of Valuation Rules.** The October 2018 Regs included rather inflexible rules for how property is to be valued for purposes of the 90 percent Asset Test. The OZ Regs 2.0 relax these rules and permit a QOF to value its assets either (i) by reference to its audited financial statements (if it has them) or (ii) at unadjusted tax basis (cost).

**Original Use Test**

6. **Adopts placed-in-service standard.** The OZ Regs 2.0 clarify that the original use of tangible property begins at the same time under the same standard as when the tangible property is "placed in service" for purposes of claiming depreciation deductions. This should provide helpful clarity with respect to property that is sold while it is under construction, but prior to its being completed and placed in service.

7. **Vacant / unused property.** In response to comments, the Treasury/IRS now recognize that vacant / unused property can qualify as good OZ property under the original use test (rather than the more difficult substantial improvement test), but only if the property has been unused or vacant for an uninterrupted period of at least 5 years prior to when any person first uses or places the property in service in the Opportunity Zone.

8. **Used property.** The OZ Regs 2.0 clarify that used tangible property will satisfy the original use requirement with respect to a QoF so long as the property has not been previously used within that Opportunity Zone in a manner that would have allowed it to depreciated or amortized by any taxpayer.

**31-month Working Capital Assets safe harbor**

9. **Clarifications.** The OZ Regs 2.0 include two helpful clarifications of the 31-month Working Capital Assets safe harbor. The safe harbor has been expanded to include costs and expenses of developing a trade or business (e.g., startup costs for an operating business). Also, the OZ Regs 2.0 clarify that the safe harbor can be applied serially, to each capital contribution made by a QOF to a QOZB (rather than a single 31-month period).

* * * * * * * * * * *

These are only our initial observations on the OZ Regs 2.0. There is still a lot of work to be done to unpack them thoroughly. Please be on the lookout for a more thorough exposition that we intend to publish in the coming weeks.
In closing, although the OZ Regs 2.0 do not answer all questions, we believe they provide sufficient certainty such that they will jump-start the formation of QOFs and spur broader investment into Opportunity Zones. Please feel free to contact us if you have any questions about Opportunity Zones.

Stephen M. Sharkey
Darryl Steinhause
Warren J. "Skip" Kessler
Gregory R. A. Dahlgren

AUTHORS

Stephen M. Sharkey
Partner
Baltimore (Mount Washington) | T: +1 410 580 3000
Baltimore (Downtown) | T: +1 410 580 3000
[email protected]

Darryl Steinhause
Partner
San Diego (Golden Triangle) | T: +1 858 677 1400
[email protected]