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IRS and Treasury Release Second Round of Qualified Opportunity Zone Guidance

On April 17th, the IRS and Treasury issued the next (and long-awaited) package of proposed regulations (the "Proposed Regulations")[1] under the "qualified opportunity zone" provisions of Section 1400Z-2 of the Code[2] (collectively with the Proposed Regulations and the proposed regulations issued on October 19, 2018 (the "Initial Proposed Regulations"), the "QOZ Rules") enacted as part of the 2017 tax reform bill. The potential tax benefits of a properly structured investment in a "qualified opportunity fund" ("QOF") include deferral of tax (until 2026) on eligible gains invested in a QOF, partial exclusion of such gains if certain holding periods are achieved, and the elimination of all post-investment gain (attributable to appreciation in the QOF investment) so long as a ten year holding period requirement is met.

Our initial reaction to the new regulations is that the IRS and Treasury are working to improve the flexibility of the rules. However, numerous uncertainties remain and we believe that interpretive ambiguities will emerge as taxpayers begin to apply the Proposed Regulations. Nonetheless, the pace of investment and capital deployment is expected to accelerate, and the new rules are particularly helpful for operating and start-up businesses that seek to establish themselves in qualified opportunity zones. This summary is not intended to be a comprehensive review of the Proposed Regulations, but contains our first take on several important provisions, presented in list format, with an emphasis on structural issues and the impact on real estate projects. Unless otherwise indicated, the summary below assumes that a QOF is established as a partnership for U.S. federal income tax purposes.

1. **Fund Structure** – Prior to the Proposed Regulations, one of the most vexing issues for market participants (especially fund sponsors looking to launch commingled funds or other programmatic strategies dedicated to opportunity zone investment) was the apparent restriction of the capital gains exclusion after a ten-year holding period to dispositions of QOF interests (and not a sale of the underlying assets). This gave rise to a

general consensus that a QOF platform would need to form separate QOF for each asset. The Proposed Regulations eliminate this apparent restriction by permitting a holder of a QOF interest with a ten-year holding period to elect to exclude from income any capital gain reported on a partnership Schedule K-1 issued to the holder by the QOF. This election should enable multi-asset funds, since properties can then be sold individually. The election appears to be available as long as the taxpayer's holding period is ten years or more, irrespective of the QOF partnership's holding period in the underlying asset. It is not clear how an investor that makes successive cash investments in a QOF would be treated for purposes of this election as assets are sold.

Importantly, the Proposed Regulations appear to allow this election only for direct Schedule K-1 allocations with respect to dispositions of property by QOFs, and not to tiered allocations from sales by "qualified opportunity zone business" ("QOZB") subsidiaries of QOFs. Since holding assets in a QOZB structure generally provides more flexibility to taxpayers under the QOZ Rules, we expect the preferred approach will be for multi-asset QOFs to hold each asset in a subsidiary QOZB partnership, and for each asset to be sold via a disposition of interests in the QOZB partnership.

2. **Recycling of Assets** – While the Proposed Regulations permit a QOF to hold the proceeds of an asset sale for up to twelve months in the form of working capital, and then reinvest such proceeds in a new qualifying asset without affecting the QOF qualification, the IRS continues to balk at the treatment of any gain on such sale where the investor's holding period is less than ten years. According to the preamble to the Proposed Regulations, the IRS "is not able to find precedent for the grant of authority…to prescribe regulations permitting QOFs or their investors to avoid recognizing gain on the sale or disposition of assets." This is likely to be a critical open question going forward, since the ability to churn assets within a QOF without compromising QOF status is a somewhat illusory benefit if the recycling generates current gain. While a QOF that holds real estate could technically consider a Section 1031 reinvestment, it is not clear how such a transaction would work within a QOF. Furthermore, the QOF would presumably need to "re-qualify" any new assets by substantially improving them.

3. **Refinancings** – The business case for many real estate development projects involves a cash-out refinancing to fund a distribution to the sponsor, investors or both, which typically occurs around the time of asset stabilization. The QOZ Rules did not previously provide much guidance on the extent to which such cash distributions are permitted, and were not even clear on the question of whether the "regular" debt allocation and basis rules under Section 752 of the Code would apply in the QOF context.

4. The Proposed Regulations clarify that where property is contributed to a QOF partnership in exchange for a qualifying investment, the taxpayer's basis in the qualifying interest is increased by the partner's share of liabilities under Section 752(a). Consequently, a leveraged distribution by a QOF to investors will not be treated as an inclusion event[3] or negate QOZ benefits, so long as the cash distribution doesn't exceed the taxpayer's basis in its QOF interest. However, the Proposed Regulations borrow principles from the "disguised sale" rules under Section 707 and provide generally that a cash-out within two years of an investment in a QOF will presumptively disqualify a corresponding amount of the initial investment from achieving QOZ benefits. It appears that debt financed distributions that occur more than two years after an initial investment are presumptively permitted. This should be welcome news to participants in real estate development projects, where debt financed cash events typically occur more than 24 months after initial funding.

5. **Vacant Land Deals; Original Use** – The Initial Proposed Regulations did not provide sufficient clarity on the treatment of investments in raw land, other than establishing that the "original use" requirement is not applicable to land. The Proposed Regulations adopt a taxpayer friendly approach and provide that so long as land meets the purchase requirement (i.e., that it is acquired in a taxable purchase from an unrelated party) and is used in a trade or business, no substantial improvement is needed either. In the Preamble, the Treasury has stated that the guardrail

against "land banking" (which contravenes the policy of the QOZ Rules) is the "trade or business" requirement, which is defined by reference to Section 162. Importantly, the Proposed Regulations also state that "the ownership and operation (including leasing) of real property is 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." These rules, taken together, are very beneficial and will permit ground-up real estate development projects to treat land as a "good" asset under the QOZ Rules so long as the land was not transferred in a tax-deferred contribution or by a related party.

6. For purposes of the original use requirement, the Proposed Regulations generally provide that (1) where a building or other structure has been vacant for at least five years prior to being purchased, the purchased building or structure will satisfy the original use requirement, and (2) the original use of purchased property commences on the date when it is placed in service in the QOZ for purposes of depreciation or amortization. This would seem to allow a building that is acquired prior to obtaining a certificate of occupancy to satisfy the requirement. Additionally, the Proposed Regulations do not impose an original use requirement with respect to leased tangible property.
7. **Promotes** – Not surprisingly, the Proposed Regulations provide that an interest in a QOF that is received for services, such as a typical "promote" or "carried interest," is not eligible for QOZ benefits. Previously, some deal sponsors had suggested that a promoted interest could enjoy the full complement of QOZ benefits irrespective of the sponsor's capital investment. The IRS has definitively stated that this position is incorrect. However, it should be noted that special allocations and preferred returns continue to be permitted as provided in the Initial Proposed Regulations.
8. **Working Capital Safe Harbor** – The Proposed Regulations provided less guidance on the working capital safe harbor than many expected, but they did include a few helpful tweaks. The safe harbor is now available for the development of a trade or business. Under the Initial Proposed Regulations, the safe harbor applied only to the acquisition, construction, substantial improvement of tangible property. Also, the 31-month window can be extended (presumably indefinitely) to allow for delays in government action, as long as the relevant application for which is completed during the 31-month period. This liberalization should benefit projects that may be subject to significant delays in obtaining any required governmental approval. Note, however, that the working capital safe harbor is only available for assets by QOZB subsidiaries, and the regular tests under the QOZ rules continue to apply to the assets held directly by the QOF.
9. **Impact of Mortgage Debt on Ten Year Exclusion** – Under the Proposed Regulations, the step-up to fair market value of a QOF interest that is disposed of after a ten-year holding period is achieved takes into account the debt on the property inside the QOF. This is a welcome clarification, as an uncertainty previously existed as to whether the step-up would only reflect net equity value and cause mortgaged property to generate gain in this scenario.
10. **Depreciation Recapture** – In an example in the Proposed Regulations, the IRS appears to have confirmed that the operation of the basis step-up in connection with a sale of a QOF interest after ten years also eliminates any gain that is attributable to "hot assets" of a partnership and depreciation recapture. This favorable rule would appear to afford taxpayer the benefit of depreciation on tangible property during the ten-year holding period without a requirement to recapture the benefit upon a sale. It is unclear whether the same result obtains where a QOF sells the depreciated assets (or its interest in a QOZB) and the taxpayer must rely on the election to exclude the capital gain allocated to it on a Schedule K-1. Furthermore, this section of the Proposed Regulations cannot be relied on until the rules are finalized, so there appears to be some "change in law" risk for sponsors who are structuring funds today.
11. **Secondary Purchases of QOF Interests** – Taxpayers can now acquire an interest in a QOF from another QOF investor (as opposed to acquiring it from the QOF itself in a "primary" sale). This aspect of the Proposed Regulations should alleviate the pressure on funds that conduct staged closings, and should also be a welcome development to

funds that want to rely on liquid trading of their interests. It also would permit an investor to enter a QOZ project after the development risk is eliminated, and enjoy QOZ benefits, albeit with a holding period that starts upon the acquisition. Furthermore, this rule may permit sponsors who hold promotes that don't initially qualify as eligible QOF interests to sell such interests to purchasers midstream.

12. **REIT QOFs** – Subject to certain requirements, shareholders in a REIT QOF (who have been shareholders of such REIT for at least ten years) can receive the benefit of the gain exclusion in connection with capital gain dividends received in respect of assets held by the REIT and sold after ten years. The REIT would need to follow certain identification and procedural requirements in such cases.

13. **Substantial Improvement** – The Proposed Regulations do not change the general requirement that the basis in qualifying property must be doubled within a 30-month period. The test is applied on an asset-by-asset basis. However, the Preamble does state that the IRS is considering whether an aggregate approach should be permitted, in an effort to ease the burden on businesses with diverse assets that would find difficulty in segregating and tracking assets.

14. **In-kind Contributions** – The Proposed Regulations permit contributions of non-cash assets into a QOF. Such contributions are subject to special rules that determine how the resulting interest is bifurcated and how the amount of the qualifying investment is computed.

15. **Feeder Funds** – Although the Proposed Regulations allow investors to contribute their QOF interests into a partnership, it does not appear that an investor with capital gain can make an initial investment into a QOF through a newly formed feeder entity.

16. **Gross Income Test Safe Harbors** – The Proposed Regulations offer additional flexibility for start-up and service businesses to meet the requirement that a QOZB must derive 50% or more of its gross income from conducting an active business in a qualified opportunity zone. A QOZB must satisfy at least one of the safe harbors provided by the Proposed Regulations and may rely on a facts and circumstances test if unable to do so. The first two safe harbors focus on services, stipulating that at least 50% of the services performed for a business by its employees (or independent contractors and their employees), either based on hours worked or amounts paid for the services, are performed in a qualified opportunity zone. The third safe harbor takes a conjunctive approach and states that a business's tangible property and management and operational functions performed for the business (each located in a qualified opportunity zone), must each be necessary to generate 50% or more of the gross income of such business. The Preamble shows examples using a wide variety of businesses, ranging from software start-ups to landscaping operations, in analyzing the application of these safe harbors. Additionally, to quell circumvention of these safe harbors, the Proposed Regulations provide that the mere presence of a P.O. box or other delivery address in a qualified opportunity zone does not constitute a factor to generate gross income by such business.

Although only proposed, taxpayers can rely on the Proposed Regulations, if applied consistently and in their entirety, with a few additional requirements for reliance on certain proposed rules (including, but not limited to, the rules concerning unimproved land). We will continue to analyze the Proposed Regulations and the way in which they are expected to apply.

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[1] REG-120186-18. The Proposed Regulations come approximately six months after the first set of proposed rules promulgated on October 19, 2018 (the “Initial Proposed Regulations”), which we discussed in a prior memorandum available here.
[2] All “section” references hereunder are to the Code unless otherwise indicated.
[3] The Proposed Regulations also introduce the concept of “inclusion events,” which are transactions involving QOF interests that will cause the holder of the QOF interest to include in income, on the earlier of the date of the inclusion event of December 31, 2026, the gain deferred as a result of making the QOF investment. Subject to several exceptions, inclusion events generally include certain taxable dispositions, gifts, distributions, redemptions, and nonrecognition transaction.