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20 Issues to Track in the Second Tranche of OZ Guidance.

Five months ago, the Treasury department issued its first tranche of proposed regulations concerning the opportunity zones (OZ) tax incentive, releasing 74 pages of regulations, a revenue ruling, an updated Q&A document and a draft of Internal Revenue Service Form 8996.

In the next few weeks, the second tranche will be released. It will include a request for comments and be followed by a public hearing. What will the second set of guidance include? The issues addressed will likely include many of those presented at the most recent public hearing and included in comment letters, as well as Treasury's assessment of areas most in need of guidance.

The following is a summary of 20 OZ guidance areas that Novogradac is closely tracking as we await the second tranche of guidance. How these issues are addressed will go a long way in determining the success of the OZ incentive in facilitating the investment of equity capital in real estate and operating businesses in distressed communities.

This list is segregated into six broad categories (and assumes a working knowledge of the OZ incentive):

- Compliance testing/calculations
- Operating businesses
- Real estate
- Renewable energy
- Corporations
- Fund management
- Compliance testing/calculations

1. 90 percent and 70 percent asset test. Last year's proposed regulations require that qualified opportunity funds (QOFs) and qualified OZ businesses use generally accepted accounting principles (GAAP) to calculate compliance with the 90 percent and 70 percent asset tests, if they have applicable financial statements. Mandating the use of GAAP to value tangible property is not a suitable valuation method for several reasons. (For additional discussion, see page 8 of the Novogradac Opportunity Zones Working Group (OZWG) Dec. 28, 2018 letter to the Internal Revenue Service (IRS).) The final regulations should allow QOFs and qualified OZ businesses to elect to use unadjusted cost basis to value tangible property regardless of whether or not they have an applicable financial statement.

2. When must a qualified OZ business begin. In order for investments in corporations and partnerships to qualify as opportunity zone property (OZ property), the statute requires that as of the time such interest was acquired, such corporation/partnership was a qualified OZ business (or, in the case of a new corporation/partnership, such corporation was being organized for purposes of being a qualified OZ business). Treasury guidance is needed that provides new businesses that are being organized for the purpose of being a qualified OZ business and existing businesses that are expanding within or into OZs time to acquire and/or improve tangible property and put such property to active use in OZs. (For additional discussion, see page 6 of the OZWG July 16, 2018

letter to the IRS.)

Operating businesses

3. Measuring 50 percent of gross income in OZs. The proposed regulations require that at least 50 percent of the gross income of a qualified OZ business be derived from the active conduct of a trade or business in the OZ. Practitioners need further guidance on how to measure that. Treasury should provide a safe harbor for the 50 percent test that could include such things as location of employee services, location of tangible property and the location where economic value is created. The determination should not be solely based on the location of the customers of the business. (For additional discussion, see page 5 of the OZWG Nov. 26, 2018 letter to the IRS.)

4. Leased property. Under the statute, OZ property must be "purchased." However, the substantially all test for qualified OZ businesses refers to tangible property owned or leased. Guidance is needed as to how to value leased property for purposes of the substantially all test, as well as how to apply the original-use requirement for leased property. (For additional discussion, see page 6 of the OZWG Nov. 26, 2018 letter to the IRS.)

5. Intangible property. The proposed regulations require that a substantial portion of the intangible property of a qualified OZ business be used in the active conduct of a trade or business in the OZ. Guidance is needed regarding (i) the meaning of the term "substantial," (ii) the meaning of the phrase "used in the active conduct of a trade or business," (iii) a method for measuring the portion of intangible property used in a business, and (iv) a method for determining whether a business's intangible property is used in the OZ. (For additional discussion, see page 16 of the OZWG Dec. 28, 2018 letter to the IRS.)

6. Reasonable working capital definition. Proposed regulations created a reasonable working capital safe harbor for qualified OZ businesses to acquire, construct and/or substantially improve tangible property. However, new and expanding operating businesses also need working capital to cover expenditures such as payroll, inventory and occupancy costs during the startup phase. A similar working capital safe harbor is needed for operating expenditures. (For additional discussion, see page 12 of the OZWG Dec. 28, 2018 letter to the IRS.)

7. Substantial improvement and aggregation of assets. Qualified OZ business property must have its original use in an OZ with a QOF or a qualified OZ business, or the QOF or qualified OZ business must substantially improve the property. Property is treated as substantially improved by the QOF or a qualified OZ business only if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the QOF or qualified OZ business exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF or qualified OZ business. To facilitate the qualification of an existing operating business as a qualified OZ business, it would be quite helpful if, at the election of the taxpayer, the substantial improvement requirement could be met by an operating business on an aggregate basis–where the acquisition of tangible property over any 30-month period exceeds the aggregate adjusted basis of existing tangible property held by the business at the beginning of a 30-month period. (For additional discussion, see page 2 of the OZWG Dec. 28, 2018 letter to the IRS.)

Real estate

8. Refinancing in excess of basis. Guidance is sought on tax consequences for debt-financed distributions from a partnership QOF, especially due to an increase in the fair-market value of a business. At issue is whether such distributions trigger recognition of deferred gain or affect

qualification for the 10-year hold fair-market-value step-up election. (For additional discussion, see page 8 of the OZWG July 16, 2018 letter to the IRS.)

9. Substantial improvement requirement for unimproved land. It remains unclear whether unimproved land needs to be substantially improved to meet the substantial improvement test and Treasury could settle that issue. (For additional discussion, see page 9 of the OZWG Nov. 26, 2018 letter to the IRS.)

10. Original use requirement and vacant buildings. The proposed regulations ask whether some period of abandonment or underuse of tangible property erases a property's history of prior use in the OZ and if so, should such a fallow period enable subsequent productive use of the tangible property to qualify as "original use." To facilitate the improvement of vacant or underused property, prior use should be disregarded for property vacant or idle for at least a one year. (For additional discussion, see page 1 of the OZWG Dec. 28, 2018 letter to the IRS.)

11. Treatment of IRC Section 1231 Gains. Section 1231 gains are required to be netted with Section 1231 losses to determine the amount, if any, of capital gains a taxpayer has. This brings into question when the 180-day window to invest Section 1231 gains begins, and whether partnerships can invest gross Section 1231 gains into a QOF. (For additional discussion, see page 4 of the OZWG Dec. 28, 2018 letter to the IRS.)

12. 31-month working capital safer harbor–issues beyond taxpayer's control. The proposed regulations provide qualified OZ businesses with a 31-month safe harbor to hold funds, but make no provision to extend that period for issues beyond their control. It is not uncommon for real estate and other developments to experience delays that are beyond the businesses control–such as delayed permitting and other municipal approvals, contract disputes, supply embargoes, labor stoppages, extreme weather events and national disasters. Additional flexibility is needed to give investors comfort that businesses experiencing these unforeseen delays will not be disqualified. (For additional discussion, see page 12 of the OZWG Dec. 28, 2018 letter to the IRS.)

13. Residential rental property and triple net leases. Guidance is needed as to whether renting property pursuant to a triple-net lease can be an active trade or business and final confirmation is desired that operating residential rental property can be an active trade or business. (For additional discussion, see page 10 of the OZWG Nov. 26, 2018 letter to the IRS.)

Renewable energy:

14. Depreciation recapture under Section 1245. The sale of a partnership QOF interest, after holding the investment for 10 years, will generally result in no net gain, because of the 10-year hold fair-market-value election. However, if the QOF has a direct or indirect partnership interest in depreciated personal property, it is unclear if the investor must recognize ordinary income recapture and a corresponding capital loss. This issue is particularly significant for the renewable energy community.

Corporations:

15. Consolidated group rules. Neither the statute nor the regulations address whether capital gains of one member of a consolidated return group of corporations can be treated as capital gain of other members of the consolidated return group so that gains may be aggregated under a single deferral election by the consolidated return group for purposes of the OZ statute. Guidance is needed as to the proper treatment of QOF investments within a consolidated group. (For additional discussion, see page 10 of the OZWG Dec. 28, 2018 letter to the IRS.)

Fund management:

16. Reasonable time to invest and working capital allowance. QOFs need time to make investments. The OZ statute explicitly states that Treasury guidance is needed to provide a reasonable time for a QOF to reinvest the return of capital from the sale of investments in OZ property. Likewise, QOFs need adequate time to assemble and underwrite initial OZ property investments. Treasury regulations provided qualified OZ businesses a safe harbor, allowing funds to be held for up to 31 months if there is a written plan in place that follows specific requirements. A similar safe harbor is needed for QOFs. (For additional discussion, see page 1 of the OZWG Nov. 26, 2018 letter to the IRS.)

17. Interim gains at fund level. In the first tranche of guidance, Treasury asked whether interim gains should be subject to tax. If yes, an additional question is whether a partnership operating as a QOF can make the election on behalf of its investors to reinvest, rather than being required to make a distribution and for the investors to then reinvest in the same or another QOF. (For additional discussion, see page 1 of the OZWG Mar. 9, 2018 letter and page 2 of the OZWG Nov. 26, 2018 letter to the IRS.)

18. Time to reinvest interim gains for purposes of 90 percent test. If QOZP is sold for cash, it is no longer a qualified investment for the 90 percent test–but the OZ statute allows a reasonable time to reinvest. Treasury could provide a definition of "reasonable time," which should be at least one year. (For additional discussion, see page 1 of the OZWG Nov. 26, 2018 letter to the IRS.)

19. Exit approach in wind-down period. The OZ statute provides a fair-market-value step-up benefit only if a taxpayer sells its investment in a QOF. That requirement is counter to the way funds generally unwind. Treasury could issue rules that provide that if a QOF disposes of assets after 10 years, pursuant to a plan of liquidation, then the QOF investors can treat such sales in a manner equivalent to selling an interest in a QOF.

20. Appreciated property contribution and carried interest. The statute and proposed regulations do not specify whether investments in QOFs must be cash, or can include property or services. Guidance is needed. If eligible investments include contributions of property, anti-abuse rules are needed to regulate contributions of appreciated property. (For additional discussion, see page 20 of the OZWG Dec. 28, 2018 letter to the IRS.)

This list of 20 OZ guidance areas that Novogradac is closely tracking is not an exhaustive list, but how they are addressed will go a long way in determining the success of the OZ incentive in facilitating the investment of equity capital in real estate and operating businesses in distressed communities. What issues would you add to this list? Email your ideas to cpas@novoco.com.

Join us in Denver
Join OZ investors, fund managers, businesses, community leaders and advisers to discuss this guidance and other timely OZ topics at the Novogradac 2019 Opportunity Zones Spring Conference, April 25-26 in Denver.

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