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Additional Takeaways From the Latest Qualified Opportunity Fund Regulations: Day Pitney

As a supplement to our alert published on April 22, this Day Pitney Advisory provides additional takeaways from the latest set of proposed regulations issued on April 17 (the 2019 regulations) regarding the qualified opportunity zone (QOZ) program under Section 1400Z.

1. Treasury defined the "original use" requirement. In order to qualify for the tax benefits afforded by Section 1400Z, an investor must invest in a QOZ through a qualified opportunity fund (QOF). To qualify as a QOF, at least 90 percent of a QOF's assets must consist of "qualified property," either directly or via ownership of an equity interest in a qualified opportunity zone business (QOZ business), which is an entity required to hold a substantial amount (70 percent or more of its assets) of qualified property. Tangible property acquired by purchase is qualified property if either (i) its "original use" in a QOZ commences with the QOF or QOZ business or (ii) the QOF or QOZ business "substantially improves" the property. The Treasury Department issued an initial set of proposed regulations in October 2018 (the 2018 regulations) that defined "substantial improvement" but reserved the definition of "original use." The 2019 regulations provide that the original use of tangible property acquired by purchase commences on the date when the purchaser (or a prior person) first places the property in service in the QOZ for purposes of depreciation or amortization, or could have done so had the person been the property's owner. While not clear, this definition appears to include situations where someone other than the property's owner (e.g., a lessee) previously used the property in the QOZ but was unable to depreciate it. This definition also makes it possible for used tangible property acquired by purchase to qualify as original use property, provided it was never used in that particular QOZ in a manner that would have allowed it to be depreciated or amortized by a taxpayer.

Any expansion of the original use standard can be viewed as a taxpayer-friendly result, because the alternative standard, substantial improvement, requires costly capital expenditures. That said, this definition may prove challenging to apply in situations where it may be unclear how and when used property was utilized by previous owners and what degree of use rises to the level of "use" in the QOZ. For example, it is unclear whether the use by a previous owner of an automobile in a QOZ 10 years ago constitutes prior use of a depreciable asset in that QOZ. Treasury may ultimately issue additional guidance to help taxpayers apply this new definition of "original use" to used property. Regardless, we view the fact that used property can qualify for original use in any situation as a positive development for taxpayers.

2. Vacant structures can qualify as original use property. The 2019 regulations introduce an additional layer to the "original use" definition with respect to vacant property. If a QOF or QOZ business purchases a building or other structure that has been unused or vacant for an uninterrupted period of at least five years prior to such purchase, the building or structure will satisfy the original use requirement. This new development should incentivize QOFs and QOZ businesses to acquire vacant buildings.

3. Land must be used in a trade or business of a QOF or QOZ business. The IRS issued Revenue

Ruling 2018-29 in conjunction with the 2018 regulations to address instances where a QOF purchases an existing building located on land wholly within a QOZ. That ruling provides that the substantial improvement test is measured by additions to the adjusted basis in the building, not the building and the land. Thus, both a building and the land thereon satisfy the substantial improvement test if additions to the QOF's basis in the building during any 30-month period exceed an amount equal to the QOF's adjusted basis in the building at the beginning of such 30-month period. The 2019 regulations confirm this result by stating that unimproved land within a QOZ and acquired by purchase is not required to be substantially improved.

Commentators raised concerns that alleviating land of the substantial improvement requirement would lead to speculative land purchasing, land "banking" and similar taxpayer actions. In response, Treasury pointed out in the preamble to the 2019 regulations that qualified property must be used in a trade or business (as defined by Section 162 of the code) and holding land for investment does not give rise to a trade or business. Consequently, land not used in a QOF or QOZ business cannot constitute qualified property. That being said, Treasury expressed additional concern that merely relying on a general application of this use requirement was insufficient to deter abuse, as QOFs or QOZ businesses could purchase unimproved land already used in a trade or business (e.g., purchasing farmland) that would satisfy the "use in a trade or business" requirement without injecting any new capital into the land, largely defeating the purpose of Section 1400Z. In response, the 2019 regulations introduce an anti-abuse provision that prohibits a QOF from relying on the rule that excludes land from the substantial improvement requirement if the land is unimproved or minimally unimproved and the QOF or QOZ business purchased the land with an expectation, intention or view not to improve the land by more than an insubstantial amount within 30 months after the purchase date. The 2019 regulations also introduce an additional, general anti-abuse rule with respect to any activities under Section 1400Z, granting the IRS broad authority to recast transactions that the IRS determines were entered into with a significant purpose of achieving a tax result inconsistent with the purpose of Section 1400Z-2. We note that these rules place added pressure on the purchase price allocation between land and property, as the IRS could argue that a QOF over-allocated the purchase price to land in order to limit the amount of costs it must incur to substantially improve the property thereon. Prior to this development, taxpayers would generally prefer to allocate less purchase price to land because land is ineligible for depreciation deductions. Obtaining an independent, third-party appraisal at the time of purchase may emerge as a best practice in many transactions.

4. Real property located partially in a QOZ can be deemed entirely within the QOZ. The 2019 regulations also introduce new rules governing situations where real property straddles the border of a QOZ. If the amount of real property located within the QOZ is substantial in comparison to the amount of real property outside the QOZ, as determined by square footage, and all the real property outside the QOZ is contiguous to at least part of the real property located inside the QOZ, then all of the property is deemed to be located within a QOZ. While this rule is clearly a beneficial outcome for taxpayers, its application may be limited. The rule as written applies only in the context of determining whether 50 percent of a QOZ business' income is derived from the active conduct of a trade or business. This distinction may lead taxpayers seeking to take advantage of the straddling rule to structure their fund with a subsidiary QOZ business instead of owning land directly at the QOF level, as application of the straddling rule to QOFs appears uncertain. The fact that the IRS and Treasury requested comments as to whether this rule should apply to other requirements of Section 1400Z-2 suggests Treasury might be considering an expansion of this rule's application to QOFs. However, absent further guidance, if a QOF intends to invest in property located within and outside a QOZ, the safer approach appears to be to implement a QOZ business structure.

5. Leased property can constitute qualified property, despite not being acquired via purchase.

Section 1400Z provides that in order to constitute qualified property, tangible property must be acquired via purchase by a QOF or QOZ business after December 31, 2017. However, the 90 percent asset test applicable to QOFs states that property held by the QOF, which can include property acquired via purchase or lease, can constitute qualified property for these purposes. Similarly, the 70 percent asset test applicable to QOZ businesses states that property used by a QOZ business can constitute qualified property. As originally drafted, these rules made it unclear whether leased property could constitute qualified property.

The 2019 regulations address this issue by providing that leased tangible property meeting certain criteria may be treated as qualified property for purposes of satisfying both the 90 percent and 70 percent tests. Analogous to the rules governing tangible property acquired by purchase, leased property must be acquired by the QOF or QOZ business under a lease entered into after December 31, 2017, and substantially all of the use of the leased tangible property must occur in a QOZ during substantially all of the lease period. Further, the lease must be a "market rate lease" and is subject to an anti-abuse rule that mirrors the anti-abuse rule described above in the context of unimproved land.

Importantly, the rules applicable to leased property have certain advantages over the rules applicable to purchased property. First, neither the original use nor the substantial improvement requirements applicable to purchased property apply to leased property. Also, unlike purchased property, leased property can be acquired from a related party-lessor without invoking the related party rule that limits the seller from owning 20 percent of the purchaser, provided that additional requirements are satisfied. The lessee may not make any prepayments to the lessor for a lease period exceeding 12 months. Additionally, the lessee must purchase tangible property valued at an amount that exceeds the fair market value of the leased personal property. Despite these added requirements, this new leasing rule affords QOFs and QOZ businesses the flexibility to lease property instead of buying it.

This development is especially relevant in the context of land that was acquired by a taxpayer prior to December 31, 2017, that is already situated within a QOZ. For example, if a landowner wanted to develop such land via a QOF or QOZ business, the only option prior to the 2019 regulations was to sell the property to the QOF or QOZ business and retain less than a 20 percent ownership interest in the QOF or QOZ business to avoid running afoul of the related party rule. While not explicitly addressed by the 2019 regulations, it appears that a ground lease entered into between a landowner and a QOF or QOZ business could accomplish the landowner's objective of permitting the QOF or QOZ business to develop the land while also permitting the landowner to retain full ownership of the land and a greater than 20 percent ownership interest in the upside of the land via an ownership interest in the purchaser QOF or QOZ business. Nevertheless, investors considering this approach must bear in mind that the QOF or QOZ business would not legally own the land. Consequently, any appreciation of the land would not be subject to tax-free treatment afforded to an investor that holds the QOF interest for more than 10 years. However, appreciation of the structures built thereon, which in many instances would represent a majority of the total value of the parcel, would be owned by the QOF and would therefore stand to benefit from the 10-year rule.

Day Pitney will continue to stay apprised of developments in this complex area of the law and will issue future client alerts as further developments occur.

Day Pitney Advisory

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