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IRS Publishes Second Round of Proposed OZ Guidance.

IRS Publishes Second Round of Proposed Opportunity Zones Guidance, Opening the Door for More and Diverse Investments in Distressed Communities

On April 17, 2019, the Treasury Department released a second set of proposed regulations relating to the operation of Qualified Opportunity Zones (QOZs) and Qualified Opportunity Funds (QOFs). While several key questions remain, the regulations remove many of the most significant hurdles that have held back investment since Opportunity Zones became law, especially for investment into new and expanding operating businesses in designated communities nationwide. With this second tranche of guidance, Treasury and the IRS made substantial progress in providing a more robust regulatory framework for investors, communities, and businesses (you can read EIG's statement on the regulations here).

Next Steps: Stakeholders have 60 days from when the regulations post to the Federal Register to submit comments on the proposed regulations. Treasury and the IRS intend to hold a public hearing on July 9, 2019. In addition to the notice of proposed rulemaking, Treasury issued a Request for Information (RFI) on data collection and tracking for QOZs, and stakeholders will have 30 days to submit public comments on the RFI. We anticipate a third and final round of regulations later this year that will focus on anti-abuse policies and reporting requirements.

Key Issues Summary

Below you'll find highlights from the proposed regulations, including many of the priorities outlined in a December 2018 comment letter from the EIG Opportunity Zones Coalition.

Timing flexibility at the QOF level: QOFs need a reasonable amount of time to deploy capital raised from outside investors into QOZ investments before the QOF should be required to meet the 90-percent asset test. This is a top-priority issue for investors, and especially for those investing in operating businesses and building a diverse portfolio of investments.

- The proposed regulations provide that for the purposes of meeting the 90-percent asset test on a testing date, the QOF does not take into account any investments received within the last six months that are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. This effectively gives QOFs a minimum of six months to make investments, a more reasonable period of time than originally proposed.
- The rules also note that failure to satisfy the 90-percent asset test on a testing date does not by itself cause an entity to fail to be a QOF but only gives rise to a penalty. The preamble states that Treasury and the IRS expect to address the penalty, including the reasonable cause exception, in future guidance.

Gross Income Test: The first tranche of proposed regulations included a requirement that 50 percent of the gross of the QOZ Business be derived from the active conduct of a trade or business in the qualified opportunity zone. The proposed regulations retain this requirement but adopt three safe harbors and a facts and circumstances test. The QOZ Business may meet the gross income test

through satisfying one of the following safe harbors:

- At least 50 percent of the services performed by employees or independent contractors (based on hours) are performed in the QOZ;
- At least 50 percent of the amount paid for services are for services performed by employees or independent contractors in the QOZ; or
- The tangible property and management and operational functions needed to produce 50 percent of gross income are located in the QOZ.

Businesses that do not qualify for these safe harbors may meet the gross income requirement based on a "facts and circumstances" test if, based on all the facts and circumstances, at least 50 percent of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ.

Interim gains: Congress linked the tax benefit to the duration of a taxpayer's investment in a QOF, not to the duration of a QOF's investment in any specific asset/business. Thus, if a QOF sells QOZ Property, the taxpayer's deferred gain should not be triggered, as long as the proceeds are invested in another qualified asset. Investors needed additional clarity on this issue, as well as the definition of the "reasonable period" mandated by the statute for reinvesting gains returned to the QOF from the sale or disposition of an asset.

- The proposed regulations provide that proceeds received by the QOF from the sale or disposition of QOZ Business Property are treated as QOZ Property for purposes of the 90-percent asset test, so long as the QOF reinvests the proceeds within 12 months. These sale proceeds must be held in cash, cash equivalents, and debt instruments with a term of 18 months or less in order to qualify.
- The rules clarify that sales of assets by QOFs do not impact an investor's holding period in the QOF.
- However, the regulations state that investors in QOF partnerships will generally still recognize interim gains under the application of ordinary tax principles. Treasury and the IRS believe that they do not have authority to depart from the otherwise operative tax provisions requiring recognition of gain and request comment on examples of tax regulations that exempt gain that would otherwise be included in taxable income.

Substantial Improvement Test for Operating Businesses: In order to facilitate investments into existing businesses as intended by Congress, QOZ Businesses should be allowed to elect to treat all of the tangible property of a trade or business as a single property for purposes of the substantial improvement test.

- The preamble states that the substantial improvement requirement is applied on an asset-by-asset basis, which will be especially cumbersome and complex for operating businesses. However, Treasury is considering applying an aggregate standard for the substantial improvement requirement and requests comments on the advantages and disadvantages of such an approach.
- Thus, for the time being operating businesses will continue to face significant challenges in determining how to meet the substantial improvement test. However, the proposed regulations provide additional clarity regarding the original use test, providing that original use is satisfied if tangible property is placed in service in a QOZ and it has not yet been depreciated by a taxpayer other than the QOF.

Working Capital Safe Harbor: The first round of regulations provided a 31-month working capital safe harbor for "QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property." In order to better facilitate investments in operating businesses, investors and

entrepreneurs needed additional clarity that the safe harbor would extend to assets necessary for the operation of a qualified business.

- The new proposed regulations provide that the working capital safe harbor now includes the development of a trade or business in the QOZ as well as acquisition, construction, and/or substantial improvement of tangible property, thus extending it to operating businesses.
- Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action, such as permitting, if the application for that action is completed during the 31-month period.
- A single QOZ Business may benefit from multiple overlapping or sequential applications of the working capital safe harbor to different infusions of capital. The examples appear to suggest that a "cliff effect" still exists if no trade or business exists at the end of the first 31-month period.

Valuation Methods: The last tranche of proposed regulations provided that, for purposes of the 90-percent asset test for QOFs or the 70-percent tangible property test for QOZ Businesses, asset values are determined using either the values reported on an applicable financial statement (if the entity has such a financial statement), or the cost of the assets (if it has no applicable financial statement).

- The proposed regulations provide that taxpayers may use the unadjusted cost basis of property or, for leased property, the net present value of lease payments.

Original Use of Vacant Property: One of the intended outcomes of this incentive is to put vacant structural property back into productive use. EIG recommended that, if property is vacant for at least one year, it should qualify as original use and not be subject to the substantial improvement test.

- The proposed regulations provide that if property has been unused or vacant for an uninterrupted period of at least five years, use of that property in the QOZ qualifies as original use.
- Treasury and the IRS were concerned that owners could intentionally cease to occupy property for 12 months in order to increase its marketability to potential purchasers after 2017.

Substantially All: The first tranche of proposed regulations provided a 70-percent threshold for defining whether "substantially all" of a QOZ Business's tangible assets are located in a QOZ, providing essential flexibility for operating businesses whose assets may move or not fall neatly within a census tract. The term "substantially all" appears in the statute in several other contexts.

- The proposed regulations did not change the 70-percent threshold for the location of tangible assets.
- In addition, the proposed regulations defined the other references to "substantially all": 70 percent for purposes of the use in the QOZ requirement, and 90 percent for the holding period requirements for both the qualification as QOZ business property and the QOF's interest in the QOZ Business. Treasury and the IRS were concerned that applying a 70-percent threshold for the holding period requirement would result in much less than half of a QOZ Business' property being used in a QOZ. As it stands, these stacked "substantially all" requirements can result in 40 percent of a QOZ Business' tangible property being used in the QOZ.

Inventory in Transit: Many public comments requested clarity that inventory in transit or temporarily stored outside a QOZ will be considered used in the QOZ and not counted against the 90 percent asset test and proposed 70 percent substantially all test.

- The proposed regulations provide that inventory and raw materials do not fail to be QOZ Business

Property because they are outside of the QOZ in transit to from a vendor or to customers.

Leased Property: The statute as written does not make it clear how leased property should be treated for the purposes of the 70 percent substantially all property test.

- The regulations provide that leased tangible property can be treated as QOZ Business Property for the 90-percent asset test and 70-percent substantially all requirement. This is particularly important for tribal communities whose land is often leased from the U.S. government.
- There is no original use requirement for leased property.
- The lease must be a "market rate lease" determined under arm's length principles.
- Leased property does not need to be acquired from an unrelated party. If the lessor and lessee are related:
- There cannot be prepayment of rent exceeding one year.
- Leased property is not treated as QOZ Business Property unless the lessee acquires through purchase QOZ Business Property with a total value of at least the value of the leased property.
- The regulations provide an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for real property other than unimproved land. If there was a plan to purchase the property for an amount other than fair market value at the time of purchase, the leased property is not QOZ Business Property.

Exiting/Winding-down QOFs: QOFs need a reasonable time to exit and sell off assets without violating the 90-percent asset test and triggering tax liability for QOF investors who have held their investments for 10 years or more. In addition, although the statute seems to permit the election to step up basis only upon sale of the interest in the QOF, typical investment funds sell off assets and redeem out investors.

- The proposed regulations do not provide a specific wind-down period, but they do provide flexibility to structure exits as sales at the QOF level. Specifically, the proposed regulations allow a QOF investor who has held its investment in the QOF for at least ten years to make an election to exclude from gross income capital gain from the disposition of QOZ Property reported on the investor's Schedule K-1 from the QOF.
- Unlike most of the guidance, the regulations state that the proposed rules covering this topic cannot be relied upon until the regulations are finalized.

Other Issues in the Proposed Regulations

Original use: Original use commences when property is first placed in service in the QOZ.

1231 gains: The regulations provided clarity that the 180-day period for 1231 gains begins on the last day of the taxable year. This issue is cause for concern, as it could create an artificial waiting period for investors who would otherwise invest their gains shortly after they are realized in order to maximize their benefit.

Land: Land can qualify as QOZ Business Property if it is used in the trade or business of the QOZ Business or QOF. Unimproved land is not required to be original use or substantially improved. However, Treasury and the IRS are concerned that treating unimproved land (such as agricultural land) as QOZ Business Property without any new capital investment or economic activity is inconsistent with the purposes of the statute and could be subject to the general anti-abuse rule.

Active conduct: Trade or business is defined by reference to the standard for deducting business expenses. The proposed regulations reserve generally on the definition of active conduct, but they

do clarify that it includes the ownership and operation (including leasing, except for triple-net leases) of real property.

Intangible property: For the requirement that a “substantial portion” of the intangible property of a QOZ Business must be used in the active conduct of a trade or business in the QOZ, “substantial portion” is defined as 40 percent.

Partner’s basis: If a QOF is organized as a partnership, the partner’s basis in the partnership interest starts at zero and is subject to adjustments under the partnership tax rules (including an increase for a partner’s share of partnership debt). As a result, partnership debt (and other adjustments to basis) should generally allow for depreciation deductions and tax-free distributions. Any actual or deemed distributions in excess of basis would be an “inclusion event” that triggers deferred gain.

Inheritance: QOF interests received through inheritance and other transfers upon death retain the tax benefits under the statute.

Acquisition of QOF interests: Taxpayers may make a qualifying investment in a QOF through the contribution of property other than cash or through the purchase of a QOF interest from an investor in a QOF.

Carried interest: Interests in a QOF received in exchange for services (e.g., carried interest) do not qualify for the benefits of the statute.

Anti-abuse rule: The IRS can recast a transaction that otherwise qualifies under the statute if a significant purpose of a transaction is to achieve a result inconsistent with the purpose of the statute.

Request for Information

- Treasury also released a Request for Information (RFI) on reporting requirements.
- The RFI announced two anticipated changes to the Form 8996 to require reporting:
- Employer Identification Number (EIN) of the QOZ Business, and
- Amount invested located in particular census tracts.
- The RFI requests comments on additional information that would be helpful for tracking effectiveness of the incentive, ensuring investments in QOZs remain an attractive option, and the costs and benefits of various methods of collecting information.**Future Guidance**

The preamble notes that within a few months, Treasury and the IRS intend to issue rules addressing information reporting requirements and the penalty under section 1400Z-2(f) for failure to meet the 90-percent asset test.

Economic Innovation Group

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