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Unanswered Questions from the April Regulatory Guidance on Opportunity Zones: Pepper Hamilton.

Qualified Opportunity Zones: Additional Regulatory Guidance – TAX UPDATE Volume 2019, Issue 3

In April, the Department of the Treasury released the much-anticipated second round of Treasury Regulations under section 1400Z-2 of the Internal Revenue Code (April Regulations). This article provides certain highlights of the regulations and notes some questions that remain unanswered.

In general, the benefits of investing in a Qualified Opportunity Fund (QOF) are available to an investor that (1) recognizes capital gain from the sale of property to an unrelated person, (2) timely invests in a QOF in an amount equal to or lesser than the amount of the gain (generally within 180 days recognizing the gain), and (3) makes a timely election with respect to its investment in the QOF, thus making a "Qualifying Investment" in the QOF. The tax benefits available with respect to a Qualifying Investment are (1) deferral of tax on the amount of the capital gain invested until December 31, 2026 (unless there is an earlier triggering event); (2) if an investor holds its interest in the QOF for at least five or seven years, 10 percent or 15 percent, respectively, of the gain invested in the QOF is permanently excluded from income; and (3) if an investor holds its interest in the QOF for at least 10 years, any gain on the appreciation of its investment in the QOF generally will not be subject to U.S. federal income tax upon the disposition of the investment.

Exiting QOFs and 'Churning'

In the April Regulations, one of the most important changes provides that taxpayers that invest in a QOF that is a partnership and that have held their interests for at least 10 years may make an election to exclude from income a certain amount of the capital gain that is realized by the partnership from the disposition of qualified opportunity zone property (QOZP) and reported on the investors' Schedule K-1 of the QOF. An additional benefit is that, in specific circumstances, although the income for which the election is made is excluded, the taxpayer will still receive a basis "step-up" corresponding to the amount of gain. This ensures that, if the cash proceeds of the sale are distributed to investors in the QOF, there typically will be no additional tax.1

This election is important because it may eliminate the need for single-asset QOFs by allowing the QOF to dispose of a variety of assets directly, after the investors have held their interests for more than 10 years. It also affords investors in a QOF the flexibility to dispose of their interests in the QOZP (through the QOF) while recognizing the 10-year appreciation exclusion without having to sell their interest in the QOF.

If a partnership QOF or partnership subsidiary qualified as an opportunity zone business (QOZB) disposes of QOZP before the investors have held their interests for 10 years, the income from that sale would flow through to the investors and would be subject to tax under the normal partnership rules. The preamble to the April Regulations noted that the Treasury Department and the IRS were not able to find authority to issue regulations permitting QOFs or their investors to avoid

recognizing gain on the sale or disposition of QOZP if the investors had not held their interests for more than 10 years. Comments were requested in that regard. This means that QOFs likely will be incentivized to hold large investment assets (e.g., real estate) for more than 10 years if investors are hoping to recognize the full QOF tax benefits.

In addition, although the gain from a disposition of QOZP must be realized by investors if they have not held their interests for more than 10 years, the proceeds of that sale generally will not be treated as a "bad" asset for the purposes of the QOF's 90 percent asset test if they are retained by the QOF as cash or certain listed cash equivalents.

Working Capital Safe Harbor for Operating Businesses

Under the April Regulations, the working capital safe harbor still can only be used by a QOZB. Thus, it is likely that QOFs may seek to retain a multiple-tier structure. The safe harbor has now been expanded to include cash designated in writing for the development of a trade or business in a qualified opportunity zone, in addition to the existing acquisition, construction and/or substantial improvement of tangible property in such a zone. This provision accommodates operating businesses. The proposed regulations also clarify that delays due to waiting for government action (e.g., zoning approval) will not cause a failure of the safe harbor if the relevant applications to the government are complete. Further, although the level of detail necessary in a written plan is not specified in the April Regulations, an example in the regulations suggests that a general business plan, without identification of a site of the business, may be sufficient to meet the requirement.

QOF Interests Received for Services

Prior regulations left the door open to the possibility that an investor that invested capital gain in exchange for an interest and also provided services in exchange for an interest might be able to treat their entire interest in the QOF as a Qualifying Investment. The April Regulations clarify that, if an investor receives an investment in a QOF in exchange for both services rendered to the QOF and capital gain contributions, then the interest in the QOF that the investor/service provider receives in exchange for services is not a Qualifying Investment.

All Uses of the Term 'Substantially All' Defined

For property to be qualified opportunity zone business property (QOZBP), during **substantially all** of the QOF's holding period for such property, **substantially all** of the use of such property must be in a qualified opportunity zone. The April Regulations tell us that "substantially all" for purposes of the holding period means 90 percent and for use means 70 percent.

The 90 percent holding period requirement also applies to the requirement that, during **substantially all** of the QOF's holding period for QOZB stock or partnership interests, the corporation or partnership must qualify as a QOZB. It is not clear, however, how this 90 percent holding period requirement for QOZBs interacts with the 90 percent asset test at the QOF level. The IRS has informally suggested that the 90 percent holding period requirement is applied on a year-b--year basis (testing whether the QOZB qualified as such for 90 percent of each taxable year). However, the April Regulations suggest that the 90 percent holding period should only be evaluated either once the complete holding period for the interest in the QOZB is known or based on the holding period on a relevant testing date.

Pepper Perspective

Although the April Regulations offer further guidance with respect to investments in QOFs, certain

questions remain unanswered. The timing and extent of additional guidance that may be forthcoming from the IRS is not clear. Thus, investors should work with their tax advisors to develop the required structures and follow the appropriate procedures to invest in a QOF in a way most likely to allow them to qualify for the tax benefits associated with a Qualifying Investment.

Endnotes

1 This is because the basis step-up in an investor's interest in the QOF still applies with respect to the gain excluded; distributions from a partnership are generally tax-free to the extent of an investor's tax basis in its partnership interest.

by Thomas Phelan

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