New guidance clarifies aspects of the Opportunity Zone program

April 23, 2019

The Treasury Department and the Internal Revenue Service (IRS) have provided additional guidance to taxpayers regarding various aspects of the Opportunity Zone program[1], releasing a second round of proposed regulations on April 17, 2019. The proposed regulations respond to a variety of concerns raised by stakeholders in public comments and also update portions of previously proposed regulations released in October 2018.

The proposed regulations clarify some of the substantive issues involving qualified opportunity funds (QOFs), qualified opportunity zones (QOZs), qualified opportunity zone business property (QOZBP) and qualified opportunity zone businesses (QOZBs).

QOF/QOZB investment, reinvestment and valuation rules

The proposed regulations provide that:

- Taxpayers may achieve gain deferral by acquiring a QOF interest from another owner, rather than by contributing to a QOF
- The 90-percent asset test applicable to a QOF does not need to take into account investments within the immediately preceding six months, provided such investments are maintained in cash, cash equivalents or short-term obligations
- QOFs and QOZBs may use unadjusted cost basis (rather than applicable financial statements) to value tangible property for compliance purposes
- Separate-entity treatment applies to consolidated group members seeking to defer gains
- To be treated as continuously satisfying the 90-percent asset test, QOFs have 12 months from the date of the disposition of qualifying assets to reinvest disposition proceeds in qualifying investments; in the interim, QOFs must keep the proceeds in cash, cash equivalents or short-term obligations in order to avoid penalties

Notably, the proposed regulations do not address whether QOFs are required to recognize gain on the sale of qualifying assets, and it appears that the Treasury Department and IRS do not believe they have the authority to decide the issue absent further clarifying legislation.

Definition of "substantially all" for QOF and QOZB holding periods

"Substantially all" means 90 percent for:

- A QOF's holding period of tangible property as QOZBP, or of a partnership interest or stock interest in a QOZB, and
- A QOZB's holding period of its tangible property as QOZBP

Treatment of leased property by QOZBs

Several generally favorable new rules address a QOZB's lease of tangible property in a QOZ, including improvements to leased property satisfying the original-use requirement and rules for leases with both related and unrelated lessors.

Measuring use of QOZBP in a QOZ and sourcing of gross income to the QOZB

The proposed regulations:

- Provide a safe harbor for inventory in transit
- Define the use of a "substantial portion" of intangible property of a QOZB in a QOZ to mean 40 percent
- Provide that trade or business is determined under Section 162 of the Internal Revenue Code
- Provide that ownership and operation (including leasing) of real property is the active conduct of a trade or business, but that merely entering into a triple-net lease with respect to real property is not the active conduct of a trade or business
- Confirm that 70 percent of tangible property must be used in a QOZ (whether owned or leased, and whether used by a QOF or a QOZB)
- Expand the safe harbor for reasonable amounts of working capital to apply to working-capital assets designated in writing for the development of a trade or business in a QOZ (not just the acquisition, construction or substantial improvement of tangible property)
- Provide three safe harbors (based on the hours worked, the amounts paid for services or the tangible property and management or operational functions performed in a QOZ), plus a facts and circumstances test, for determining whether 50 percent of gross income is derived from the active conduct of a trade or business in a QOZ

Transactions triggering the inclusion of a deferred gain in a QOF

The proposed regulations provide a non-exclusive list of "inclusion events" that trigger inclusion of a deferred gain under a wide variety of circumstances for QOF partnerships and corporations, including with respect to distributions, transfers by gift and certain non-recognition transactions for corporations. For QOF partnerships, debt-financed distributions may not trigger gain inclusion under certain circumstances. However, "mixed-fund" allocation rules provide an added layer of complexity to tracking adjustments to basis, including Section 752(a) liabilities, and related partnership items between the eligible gain and non–eligible gain contributions. The following section covers this in greater detail.

A closer look at QOF inclusion events

Under Section 1400Z-2, the amount of gain that is deferred if a taxpayer makes an equity investment in a QOF will be included in the taxpayer's income in the taxable year that includes the earlier of i) the date on which the qualifying investment is sold or exchanged, or ii) December 31, 2026. The proposed regulations label the event that triggers the inclusion of a deferred gain in gross income as an "inclusion event." Subject to certain exceptions, the proposed regulations provide that:

- An inclusion event results from a transfer of a qualifying investment in a transaction to the extent the transfer reduces the taxpayer's equity interest in the qualifying investment for federal income tax purposes; and
- Except as otherwise provided in the proposed regulations, a transaction that does not reduce a taxpayer's equity interest in the taxpayer's qualifying investment is also an inclusion event to the extent the taxpayer receives

property from a QOF in a transaction treated as a distribution for federal income tax purposes.

For this purpose, “property” is generally defined as money, securities or any other property, other than stock (or rights to acquire stock) in the corporation that is a QOF that is making the distribution. The rationale for such treatment is that it is necessary to treat such transactions as inclusion events to prevent taxpayers from “cashing out” a qualifying investment in a QOF without including in gross income any amount of their deferred gain.

The proposed regulations provide taxpayers with a non-exclusive list of inclusion events, including but not limited to:

- A taxable disposition (for example, a sale) of all or part of a qualifying investment in a QOF partnership, or of a qualifying investment in a QOF corporation
- In certain cases, a transfer by a partner of an interest in a partnership that itself directly or indirectly holds a qualifying investment
- The transfer by gift of a qualifying investment
- The distribution to a partner of a QOF partnership of property that has a value in excess of the basis of the partner’s qualifying QOF partnership interest
- A redemption of qualifying QOF stock that is treated as an exchange of property for the redeemed qualifying QOF stock under Section 302
- A disposition of qualifying QOF stock in a transaction to which Section 304 applies
- A liquidation of a QOF corporation in a transaction to which Section 331 applies
- Certain non-recognition transactions under the Internal Revenue Code, including liquidations, Section 351 transfers and various reorganizations enumerated under Section 368

Investors in QOF partnerships should note this language in the preamble to the proposed regulations:

> “Partnership distributions in the ordinary course of partnership operations may, in certain instances, also be considered inclusion events. Under the proposed regulations, the actual or deemed distribution of cash or other property with a fair market value in excess of the partner’s basis in its qualifying QOF partnership interest is also an inclusion event.”

While the qualifying investment provides for a zero basis (subject to additional step-ups in basis of 10 percent and five percent, under Section 1400Z-2), the proposed regulations recognize that a partner’s basis in its QOF partnership interest may be increased by its share of partnership liabilities under Section 752(a). As a result, debt-financed distributions to investors are, under certain circumstances, permissible. However, caution is in order because rules similar to disguised sale rules under Section 707 apply to distributions within the first two years of an investor’s contribution to the QOF, which may result in the investor’s original qualifying investment being re-characterized as a non-qualifying investment.

Additionally, investors with “mixed-fund” investments in a QOF partnership (that is, contributions consisting of both deferred gain and other non–deferred gain investments) need to be aware that the proposed regulations create fairly complex rules to track both components of an investor’s mixed-fund investment to ensure that the eligible gain is not cashed out early.

Dentons will discuss these rules further, as well as addressing other aspects of the proposed regulations, in future client alerts. In the meantime, please contact the authors of this alert (listed at right) or your Dentons relationship partner if you have questions.

Public comment period

A public hearing on the proposed regulations is scheduled for Tuesday, July 9, 2019. Comments may be submitted to the IRS for a period of 60 days from the date the proposed regulations are posted in the Federal Register.

The proposed regulations apply for taxable years beginning on or after the date of their publication in the Federal Register as final regulations. QOFs may rely on the proposed regulations for taxable years that begin before such date, but only if they apply the proposed regulations entirely and consistently.

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1. Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended.↩

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