Qualified Opportunity Zones Alert

Second Set of Treasury Regulations on Opportunity Zones Welcome Guidance; Should Spark Investment

April 2019

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As we have previously alerted you, on Wednesday, April 17, 2019, the Internal Revenue Service ("IRS") and the United States Department of the Treasury issued the highly anticipated second set of proposed regulations (the "2019 Regulations") regarding the Qualified Opportunity Zone Program (the "QOZ Program"). The 2019 Regulations are a follow-up to the initial promulgation by the IRS of Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "Code"), and the issuance of an initial set of regulations on the QOZ Program in October 2018 (the "2018 Regulations"). For a summary of Code Sections 1400Z-1 and -2, the 2018 Regulations and a general overview of the OZ Program, see CSG's October 2018 Qualified Opportunity Zones Alert.

The 2019 Regulations provide critical information for investors, investment bankers, real estate developers, Qualified Opportunity Funds ("QOFs"), real estate project sponsors, and venture capitalists, to name a few, generally relaxing the rules applicable to investing in QOZs and answering a number of questions previously left unanswered. Overall, the new guidance appears investor and developer-friendly and should spur activity in terms of the deployment of QOZ-ready funds that have been sitting on the sidelines pending clarification of the rules.

Real Estate Development Made Easier

A major question that remained unanswered after the issuance of the 2018 Regulations was how real estate developers could satisfy the "original use" test in Code Section 1400Z-2 for both real property and tangible property. The 2019 Regulations provide the following clarifications:

- Land can satisfy the "original use" test as long as it is used in a trade or business of the QOF or the QOZ business. If the land is not used as part of a trade or business, the QOF or the QOZ business must substantially improve the land within 30 months of its acquisition.
- Tangible property acquired by a QOF or a QOZ business by purchase can satisfy the "original use" test if it is first "placed in service" by the QOF or the QOZ business as the buyer. The term "placed in service" refers to the date when the tangible property was first placed in service in the QOZ for purposes of depreciation or amortization. Thus, tangible property located in a QOZ that is depreciated or amortized by a taxpayer other than the QOF or QOZ business would not satisfy the "original use" requirement. Conversely, however, tangible property – other than land – located in a QOZ that has not yet been depreciated or amortized by a taxpayer other than the QOF or a QOZ business would satisfy the "original use" requirement.
- Prior to the 2019 Regulations, if an investor acquired property in a QOZ – including vacant property – that investor was required to "substantially improve" that property, as measured by additions to the basis of the building, not the land, equal to at least the amount of the purchase price allocated to such building plus a dollar. Under the new guidance, land and buildings that have been vacant, abandoned or dilapidated for five years prior to being purchased by a QOF will qualify as "original use" property investments, meaning the investor is not required to meet the "substantial improvement" test. This should promote the redevelopment of existing abandoned properties located in QOZs, and possibly make it easier to rehabilitate brownfields located in QOZs.

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Relaxed Rules for QOFs

As you may recall, QOFs are subject to the "90% asset test" which generally requires that 90% of the assets of the QOF consist of QOZ property, determined by the average percentage of QOZ property held in the QOF as measured (1) on the last day of the first 6-month period of the taxable year of the QOF and (2) on the last day of the taxable year of the QOF. Under the 2018 Regulations, new QOFs were given the ability to delay the start of their status as a QOF and, thereby, the start of the testing date for purposes of the 90% asset test. The question became what happens when an existing QOF that receives new capital from an equity investor shortly before the QOF is subject to its semi-annual test. Recognizing that existing QOFs deserve the same or similar treatment as a new QOF, the 2019 Regulations clarify and address concerns regarding the triggering of the 90% asset test in two (2) significant ways:

First, the 90% asset test will be applied without taking into account any investments received by a QOF in the six (6) months preceding any testing date, subject to certain requirements as to how those newly contributed assets are held. This clarification addresses the concern that a QOF would not be able to accept investor funds immediately before one of the testing dates described above, unless such cash could be invested right away.

Second, if a QOF sells QOZ property (QOZ business property, QOZ stock or QOZ partnership interests), the QOF has 12 months to reinvest any cash proceeds received by the QOF from such sale before such cash becomes a so-called "bad asset" for purposes of the 90% asset test. In addition, as long as the cash received by the QOF is reinvested within the 12-month period described above, the recycling should not result in the inclusion of any of the investor's initially deferred gain. However, the 2019 Regulations have not alleviated the issue of gain leakage to the investor to the extent that any gain is recognized from the QOF's sale of an underlying asset and is not subsequently reinvested within the 12-month period. Any such gain will be allocated to investors in accordance with normal tax rules, and investors will be required to pay tax on such gain.

Expansion of the Working Capital Safe Harbor

Under Code Section 1400Z-2, less than 5% of the average aggregate unadjusted bases of the QOZ business's property can consist of "nonqualified financial property" – excluding reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less. The 2018 Regulations contained a working capital safe harbor for purposes of the above for QOZ businesses that acquire, construct, or rehabilitate tangible business property, providing that such QOZ businesses can treat cash as reasonable working capital if certain requirements are met, including a written plan identifying how the cash will be used, a written schedule consistent with the ordinary business operations of the QOZ business for deploying the cash within 31 months, and the QOZ business's actual compliance with the schedule.

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The 2019 Regulations further expand the working capital safe harbor as follows:

- The safe harbor will apply to QOZ business that will be developing a trade or business. The safe harbor will apply to various QOZ business expenditures, including payroll, inventory and occupancy costs during the business's start-up phase.
- The safe harbor will be extended if capital deployment delays are attributable to governmental action on completed applications, as long as such applications were submitted during the safe harbor period.
- A QOZ business can have multiple overlapping applications of the 31-month safe harbor, as long as each one satisfies the aforesaid requirements.

Treatment of Leases of Tangible Property

The 2019 Regulations clarify that leased tangible property generally will be treated as QOZ business property for purposes of satisfying the 90% asset test applicable to QOFs and for purposes of the "substantially all" requirement, if the lease was entered into on or after December 1, 2018 and if substantially all of the use of the leased property is in a QOZ for substantially all of the period for which the property is leased by the QOF or the QOZ business.

Unlike with respect to property acquired by a QOF or QOZ business by purchase, there is no requirement that the lessor and the lessee of the tangible property be unrelated parties. While this may be helpful in structuring transactions involving investors who have in the past and already own properties in QOZs, certain additional rules will apply to such transactions, including that the lease is a "market rate lease" (no triple net leases as explained below) and that the QOF or QOZ business does not make any prepayments under the lease that exceeds 12 months. Also worth noting is that there is no original use requirement or substantial improvement requirement imposed on leased tangible property due to the nature of such property.

Investing in Operating Businesses

Definition of "Substantially All". In the 2018 Regulations, the IRS did not define the term "substantially all" in each of the various places it appears in Code Section 1400Z-2 of the Code. The 2019 Regulations clarify that (1) in testing the use of QOZ business property in a QOZ, the term "substantially all" means 70%; and (2) "substantially all" as used in the holding period context means 90%.

50 Percent Gross Income Test for QOZ Businesses. The 2018 Regulations require that a business derive at least 50 percent of its gross income from the active conduct of a trade or business in the QOZ. This requirement initially prompted many to believe that this rule would disqualify many operating businesses that conduct sales in or provide services to many different locations in the country. The 2019 Regulations provide welcome guidance on the issue. Under the 2019 Regulations, a business funded by a QOF and located in a QOZ can qualify for the tax incentives if it meets one of three safe harbors: (1) at least 50%

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of the hours the employees or contractors work are spent in a QOZ; (2) at least 50% of the company's services are performed in the QOZ; or (3) (i) the tangible property of the business is in a QOZ and (ii) the management and operations of the business are in the designated QOZs. In addition, if none of the safe harbors applies, a general facts and circumstances test can be administered.

Use of Intangibles. The 2018 Regulations require that a substantial portion of the QOZ business's intangible property be used in the active conduct of its trade or business in a QOZ. The 2019 Regulations define the term "substantial" as 40%, leaving a fair amount of leeway in terms of the QOZ business's asset composition.

Inventory. Code Section 1400Z-2 provides that QOZ business property means tangible property used in a trade or business of the QOF if, during substantially all of the QOF's holding period for such property, substantially all of the use of such property is in a QOZ. The 2019 Regulations clarify that inventory, including raw materials, of a trade or business does not fail to be used in a QOZ solely because the inventory is in transit from a vendor to a facility of the trade or business that is in a QOZ, or from a facility of the trade or business that is in a QOZ to customers of the trade or business that are not located in a QOZ. This is a welcome break for QOZ businesses that focus on exported goods or services, or on domestic markets outside the QOZ.

Active Conduct of a Trade or Business. The 2019 Regulations provide that businesses taking advantage of the program must be active. Critically, triple net leases will not be part of the QOZ Program, as the main benefit of a triple net lease property is the passivity it allows the owner. The 2019 Regulations provide: "The ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer."

Events Causing Inclusion of Deferred Gain

The 2018 Regulations provided that the amount of gain that is deferred if a taxpayer makes an equity investment in a QOF, i.e. a qualifying investment, will be included in the taxpayer's income (such event referred to as an "inclusion event") in the taxable year that includes the earlier of (a) the date on which the qualifying investment is "sold or exchanged", or (b) December 31, 2026. In light of the uncertainty surrounding the language "sold or exchanged" and how various non-sale or exchange dispositions should be treated, the 2019 Regulations clarify that, subject to certain enumerated exceptions, a gain inclusion event results from a transfer of a qualifying investment in a transaction to the extent such transfer reduces the taxpayer's equity interest in the qualifying investment for Federal income tax purposes.

The 2019 Regulations provide taxpayers with a nonexclusive list of inclusion events, which include the following:

- A taxable disposition of all or part of a qualifying investment in a QOF partnership or QOF corporation;
- A taxable disposition of interests in an S corporation which itself is a direct investor in a QOF corporation

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or partnership if, immediately after the disposition, the aggregate percentage of S corporation interests owned by the S corporation shareholders at the time of its deferral election has changed by more than 25%;

- Certain transfers by a partner of an interest in a partnership that itself directly or indirectly holds a qualifying investment;
- Transfers by gift of a qualifying investment;
- The distribution to a partner of a QOF partnership of property in excess of the basis of the partner's qualifying QOF partnership interest;
- Certain distributions of property with respect to qualifying QOF stock under Code to the extent it is treated as a gain from the sale or exchange of such property;
- Certain redemptions of qualifying QOF stock;
- Disposition of qualifying stock under certain circumstances;
- Certain liquidations of QOF corporations; and
- Certain nonrecognition transactions, including liquidations of a QOF corporation under Code Section 332, Code Section 351 stock transfers, certain Code Section 368 stock for stock exchanges, and certain types of reorganizations, recapitalizations, distributions and other transfers.

Each of the aforesaid transactions would be an inclusion event because each would reduce or terminate the QOF investor's qualifying investment for Federal tax purposes or would constitute a "cashing out" of the QOF investor's qualifying investment. As a result, the investor will recognize all, or a corresponding portion of, its deferred gain under Code Section 1400Z-2.

Distributions in Light of the Zero Basis Rule

Because of the fact that, under the Code, an investor's basis in his or her initial QOF investment is zero, questions have arisen as to whether investors will be able to receive tax-free distributions out of the QOF, particularly with respect to refinancing proceeds, or whether investors will be eligible to deduct their share of depreciation. Notably, the 2019 Regulations answer one of these questions, but not so much the other.

With respect to the distribution of refinancing proceeds, the 2019 Regulations clarify that a distribution by a QOF to a partner is generally taxable to that partner only to the extent that the distribution exceeds the partner's basis in its interest in the QOF. Under the general partnership tax rules, a partner in a partnership receives a basis step-up for his or her share of any underlying debt. Therefore, depending on how the debt gets allocated, an investor should be able to receive a tax-free distribution of refinancing proceeds to the extent of the investor's share of such debt and any basis in his or her QOF investment generated as a result of the 5-year and 7-year basis step up, or as a result of any tax paid as of December 31, 2026.

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The 2019 Regulations do not answer the question of whether a QOF investor can deduct his or her share of depreciation. Due to lack of basis in the investor's initial QOF investment, any depreciation amounts will likely be suspended losses which can be used in the future once the investor generates sufficient basis in its QOF interest. It is not clear whether any depreciation taken will be subsequently recaptured once the investor elects to step up his or her basis in its QOF interest on the ultimate disposition of the asset.

Election for Direct Investors in QOF Partnerships and QOF S Corporations

Under the general rules applicable to partnerships and S corporations, when a QOF partnership or QOF S Corporation (each, a "QOF Pass-Through Entity") disposes of QOZ property, the capital gain resulting from such disposition will be reported on the QOF Pass-Through Entity's Schedule K-1. The direct investors in these QOF Pass-Through Entities would then have their pro-rata share of these capital gains attributed to them as taxable income. To preserve the intent of the QOZ Program, the 2019 Regulations provide that if an investor has held an interest in a QOF Pass-Through Entity for at least 10 years, and the QOF Pass-Through Entity disposes of QOZ property after such 10-year holding period, the investor may make an election under Code Section 1400Z-2(c) to exclude any capital gains arising from such disposition reported on Schedule K-1 from the investor's gross income. To be valid, the investor must make his or her election for the taxable year in which the capital gain recognized by the QOF Pass-Through Entity would be included in the investor's gross income. For basis purposes, such excluded amount is treated as an item of income described in Code Sections 705(a)(1) or 1366, thereby increasing the investor's basis in his or her partnership interests or S corporation shares, as applicable, to such amount.

Interestingly, the aforesaid election is available only with respect to sales of property by a QOF. Therefore, if a QOF structure is in place whereby a QOZ business holds the underlying property, and it's the QOZ business – and not the QOF – that sells the asset, it is not clear whether this election would apply to exclude from tax any gains arising from the disposition of such asset by the QOZ business. Moreover, it should be noted that the IRS has made it explicitly clear that the aforesaid election cannot be relied upon until the 2019 Regulations are finalized. Therefore, structuring multi-asset funds in hopes that investors can exit such funds tax-free by making the aforesaid election should be approached with caution.

Certain Other Transfers of QOF Interests

REIT Asset Transfers. QOF real estate investment trusts (each a "QOF REIT") may designate special capital gain dividends, not to exceed the QOF REIT's long-term gains on sales of QOZ property. If a shareholder holds QOF REIT shares as a qualified investment, those special capital gain dividends are tax free to such shareholder, who could have elected a basis increase in case of a sale of the QOF REIT shares.

Transfers of Property by Death. Under the 2018 Regulations, it wasn't clear whether the children or heirs of an investor in a QOF would receive the benefits of the QOF investment. In fact, many have answered

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this question in the negative. Critically, the 2019 Regulations provide that, upon the death of the investor, neither a transfer of the qualifying QOF investment to the deceased owner's estate nor the distribution by the estate to the decedent's legatee or heir will be deemed an inclusion event, thereby preserving the tax benefits of the qualifying investment. Similarly, neither the termination of grantor trust status by reason of the grantor's death nor the distribution by that trust to a trust beneficiary by reason of the grantor's death will be treated as an inclusion event for purposes of Code Section 1400Z-2(b). Furthermore, the recipient of a qualifying investment by reason of the death of the owner may tack the decedent's holding period to his or her own. In each case, the recipient of the qualifying investment has the obligation, as under Code Section 691, to include the deferred gain in gross income upon any subsequent disposition of the qualifying investment by that recipient.

Holding Periods

For purposes of Code Section 1400Z-2(b)(2)(B), an investor's holding period in a QOF begins on the date of his or her investment in the QOF. A QOF investor's holding period for his or her qualifying investment does not include the period during which the QOF investor held property that was transferred to the QOF in exchange for the qualifying investment. For example, if an investor transfers a building that he or she has owned for 10 years to a QOF corporation in exchange for qualifying QOF stock, the investor's holding period for the qualifying QOF stock, for purposes of Code Section 1400Z-2, begins on the date of the transfer, not the date the investor acquired the building.

Similarly, if an investor disposes of its entire qualifying investment in QOF 1 and reinvests in QOF 2 within 180 days, the investor's holding period for its qualifying investment in QOF 2 begins on the date of its qualifying investment in QOF 2, not on the date of its qualifying investment in QOF 1. Unlike QOFs, which can dispose of QOZ assets and reinvest the proceeds into other QOZ assets within 1 year, QOF investors must maintain their investment in their initial QOF in order to preserve their holding periods.

However, a QOF shareholder's holding period for qualifying QOF stock received in a qualifying Code Section 381 transaction (in which a corporation acquires all or substantially all of another corporation's assets), provided the acquiring corporation is a QOF immediately thereafter, or received in a recapitalization of a QOF, includes the holding period of the QOF shareholder's qualifying QOF stock exchanged therefor. Similar rules apply to QOF stock received in a qualifying Code Section 355 transaction (in which a corporation makes a tax-free distribution to its shareholders of securities in a controlled subsidiary). In these instances, the Treasury Department and the IRS have determined that the shareholder's direct equity investment in the initial QOF continues. Tacked holding period rules apply in the same manner with respect to a QOF partner's interest in a QOF partnership, for example, in the case of a partnership merger where the QOF partner's resulting investment in the QOF partnership continues.

Similar rules apply for purposes of determining whether the "original use" requirement commences with the acquiring corporation (after a qualifying Code Section 381 transaction in which the acquiring

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corporation is a QOF immediately thereafter) or the controlled corporation (after a qualifying Code Section 355 transaction). In each case, the acquiring corporation or the controlled corporation satisfies the original use requirement if the target corporation or the distributing corporation, respectively, did so before the transaction.

General Anti-Abuse Rule

Proposed Treas. Reg. Section 1.1400Z2(f)-1(c) provides a general anti-abuse rule pursuant to Code Section 1400Z-2(e)(4)(C), which provides that "the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including (...) rules to prevent abuse." Furthermore, the Commissioner can recast a transaction, or series of transactions, for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of the regulations. The Treasury Department and the IRS want to ensure that QOFs and QOF investors abide by both the letter and the spirit of the QOZ regulations.

Summary

The newly proposed 2019 Regulations provide the long-awaited certainty and clarity to taxpayers, developers, investment bankers and others on the intricacies of the QOZ Program. While neither the 2018 Regulations nor the 2019 Regulations are in their final form and a hearing on the 2019 Regulations is scheduled for July 9, 2019, investors and QOFs alike are permitted to rely on them with retroactive effect, except to the extent set forth above. The added clarity provided with the 2019 Regulations, combined with the first set of regulations issued last October, should provide much-needed encouragement to taxpayers not only to invest in QOFs but also to increase the amount of investment located in QOZs.

CSG stands ready to assist you with your investments in QOFs.

For more information concerning how the Opportunity Zone Program may benefit you as either an investor, developer or business owner, please contact your CSG attorney or the authors listed below.

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