New Qualified Opportunity Zone regulations offer additional guidance.

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On April 17, 2019, the IRS and Treasury released the much-anticipated second set of proposed regulations implementing the qualified opportunity zone (QOZ) incentive program. The new regulations add clarity for many issues, but still leave some questions unanswered. The need for additional guidance is acknowledged throughout the regulations, and comments are requested on many topics. This of course means that more guidance is forthcoming. With these regulations being in proposed form, the requested comments that are provided by interested parties should result in further clarification when these regulations are reissued in final form. Based on recent comments from Treasury, it is unclear whether there will be a third set of regulations as previously communicated or if the only remaining guidance will be the final version of the proposed regulations issued yesterday. With that in mind, the most important provisions of the new proposed regulations are discussed below.

50 percent gross income limitation

Significant questions were submitted in previous comment letters regarding the limitation that 50 percent of the QOZ business's income result from "the active conduct of business" within the QOZ. Concerns arose based on businesses that may, for example, create a product within a QOZ but sell the product outside of the QOZ. The new regulations have addressed this issue, creating three distinct safe harbors and a general facts and circumstances safe harbor that businesses can look to in satisfying this requirement.

These safe harbors allow a business to meet the above requirements when:

1. Fifty percent of the work hours for services of the trade or business performed by employees and independent contractors occurred within the QOZ

2. Fifty percent of the amounts paid by the trade or business for services performed by employees and independent contractors occurred with the QOZ

3. Both the tangible property of the business in the QOZ and the management or operations necessary to generate 50 percent of gross income of the trade or business are within the QOZ

If a QOZ business fails to meet any of these safe harbors, they can still otherwise establish by facts and circumstances that 50 percent of the gross income of the trade or business is derived from active conduct of the trade or business in the QOZ

Original use of tangible property acquired by purchase

A significant clarification in the new regulations came in the way of the definition of "original use" as it relates to the requirement for tangible property to have original use commence with the QOZ. Generally, the new regulations define original use as beginning when the property is first placed in service in a way that would allow the taxpayer to depreciate or amortize it. In this light, previously depreciated property generally does not qualify.

One exception to this general rule comes in the vacancy provision, stating that if a building or other structure has been vacant for at least five years prior to being purchased by a QOF or QOZ business, it can qualify again as having its original use commence with the QOZ. This appears to apply irrespective of whether the building or structure has been previously placed in service or otherwise depreciated.

The new regulations also carve out special rules for the original use requirements of various other types of property. For example, improvements made to leased property can qualify as having their original use in the QOZ to the extent of their unadjusted cost basis. The regulations also state that holding land for investment generally does not give rise to a trade or business, and prescribes additional anti-abuse rules regarding acquiring land.

Leased tangible property

The ability to include leased property within a QOZ was included with the original proposed regulations, however the new regulations have provided some additional guidance regarding its inclusion as QOZ business property. The new regulations also discuss how leased property can be considered QOZ business property for purposes of satisfying the 90-percent asset test, and the "substantially all" requirements under 1400Z-2(d)(3)(A)(i). This generally requires that the tangible property be acquired under a lease entered into after December 31, 2017, with substantially all of the property in a QOZ during substantially all of the period of the lease.

Significantly, there is no substantial improvement requirement to leased tangible property, however to limit abuse the new regulations impose the following requirements:

- the lease must be a "market rate lease,"
- rent paid to related parties is limited
- for leased property to be counted as qualified property, the lessee must also acquire other tangible QOZ property at least equal in value to the leased property, within 30 months in a way, mimicking the substantial improvement test)
- when leasing real property, at the time the lease is entered into there cannot be a plan, intent, or expectation of purchase by lessee QOF for less than fair market value

For valuation purposes in satisfying the 90-percent asset test, leased property can consider the applicable financial statement valuation method, or an alternative valuation method as described in the regulations.

Dispositions triggering inclusion of originally deferred gain

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The original regulations discussed the treatment of the originally deferred gain upon sale or disposition, and the new regulation expand on that discussion by setting forth additional "inclusion events" that will result in recognition of the deferred gain. Generally, inclusion of the deferred gain will occur any time a transaction reduces the taxpayer's equity interest in the qualifying investment for Federal income tax purposes. Beyond that, a taxpayer will also recognize the deferred gain to the extent the taxpayer receives property in a transaction that is treated as a distribution.

The regulations include a non-exhaustive list of 11 examples that include obvious events such as a sale of the investment or partnership interest, and a distribution to a partner in excess of partnership interest. These examples also contain some more nuanced events such as nonrecognition transactions involving stock liquidations, stock-for-stock exchanges, triangular reorganizations, and certain asset reorganizations. Ultimately, any transaction in which the taxpayer is deemed to have "cashed-out" all or a portion of their investment will likely result in full or partial recognition of the originally deferred gain.

Timing of basis adjustments

Basis adjustments that reflect the recognition of deferred gain will generally be made immediately after the deferred capital gain is recognized as income. If a basis adjustment is made as a result of reduced ownership, redemption, or certain distributions, there are special rules for adjusting the basis before determining the tax effects of the inclusion event. The regulations also clarify that the taxpayer can elect to recognize the basis adjustment immediately before the taxpayer disposes of the QOF investment, subject to some additional clarifications regarding QOF partnership assets.

Amount includable

Following an inclusion event, the taxpayer will generally include in taxable income the lesser of two values, less the taxpayer's basis. The two values for the purposes of this calculation are 1) the fair market value of the portion disposed of, or 2) the amount that bears the same ratio to the remaining deferred gain as the first amount bears to the total fair market value of the qualifying investment in the QOF immediately before the transaction. Please note, the regulations also describe special rules for calculating the includable amount for partnerships, shareholders in s-corporations, and QOF owners.

Definition of "substantially all" for the holding periods and asset tests

The phrase "substantially all" is used many times throughout the QOZ statutes and regulations, and the new regulations provide some additional guidance on its definition. Specifically, in the context of "use" as it relates to testing the use of QOZ business property in a QOZ, "substantially all" means 70-percent. Whereas in the context of the holding period requirements, "substantially all" means 90-percent. Further, the definition of "substantially all" in the context of ownership of tangible property remains at 70-percent as discussed in the previous regulations. In addition, for the requirement that a substantial potion of intangible property of a QOZ business entity must be used in the active conduct of a trade or business in the QOZ, "substantial portion" is defined as 40 percent.

Pass-through guidance, including relief for asset sales

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Perhaps the largest benefit of the QOZ incentive package is the potential for permanent exclusion of gains realized on QOZ investments held for more than ten years (if the investor meets certain other criteria). However, the statutory language (Code Sec. 1400Z-2(c)) is restrictive in that it suggests an investor must directly sell their interest in a qualified opportunity fund to realize this benefit. Practically, this is not how fund investments have usually worked; funds typically realize gains by selling their assets, investors do not usually sell their interests in funds. This problem is particularly acute for multi-asset funds, where a potential purchaser may only want to buy one of several assets in a fund.

Recognizing this practicality, the IRS and Treasury have proposed a special election for an investor in a qualified opportunity fund, organized as a passthrough entity, who has held their investment in the fund for at least ten years. In this case, the investor will have a special election available to them to exclude gains (including particular items of gross gain) reported to them on Schedule K-1 from the fund. An investor making this election would still increase their basis in their partnership interest by the amount of the excluded gain, thus preserving the permanent nature of the exclusion.

Pass-through guidance, including relief for asset sales (continued)

The proposed regulations also address another potential trap for the unwary, where an investor who does actually sell their interest in a qualified opportunity fund after ten years (and makes the election under Code Sec. 1400Z-2(c)). Under the statute alone, it was possible that an investor selling their interest would properly receive a net gain or loss of $0, but have significant components of ordinary income and capital loss by application of Code Sec. 751 (a very bad result). Through a mechanism of adjusting the outside basis in the partner's interest in the QOF to equal the fair market value of that interest, including debt, and adjusting the inside basis of the qualified opportunity fund's assets (in a manner similar to Code Sec. 743(b)), the proposed regulations seek to prevent this result.

Finally, the proposed regulations give guidance for taxpayers with mixed investments in qualified opportunity funds structured as partnerships, that is, where only a portion of their interest qualifies for the suite of QOZ incentives. Accordingly, even though separate tracking of qualified vs non-qualified investments is required for Sec. 1400Z-2 purposes, partners are still treated as holding a single partnership interest, a single basis and a single capital account for purposes of the partnership taxation rules of Subchapter K.

Closing thoughts

In addition to those discussed above, the proposed regulations also provide guidance on the following items:

- For section 1231 gains, only the net capital gain portion after netting section 1231 gains and losses is eligible gain for section 1400Z-2 benefits. The 180-day investment period for section 1231 gains begins on the last day of the taxable year.
- Safe harbor for inventory in transit for asset test purposes
- Defining a reasonable period of time to sell assets and reinvest proceeds into a QOF without causing a test failure as one year
- A six-month grace period from receipt of cash from investors to purchase assets without causing a test failure
- A modification to the working capital safe harbor, allowing for additional time beyond 31 months to deploy capital if the failure is caused by a governmental delay
- Adopts rules similar to those applicable to empowerment zones that permit a square footage allocation to determine qualifying portion of property that straddles a QOZ census tract and a non-qualified census tract.
- Several complex provisions governing C corporations, including the exclusion of QOF stock from the definition of "stock" for purposes of consolidated return rules.

As noted above, despite this additional guidance there remains significant open questions. The comments that have been solicited throughout the regulations will be discussed in part in a public hearing scheduled for July 9, 2019. Additionally, the Department of Treasury also released a formal request for comments regarding enhanced data collection procedures and reporting requirements related to QOZ investments.

Despite this new set of regulations, it still is imperative that taxpayers discuss the tax benefits of QOZs and QOFs with experienced professionals before pursuing the benefits of QOZs.

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