THE NATIONAL LAW REVIEW

Much-Needed Clarity Finally Arrives for Reaching the Land of OZ

Sills Cummis & Gross P.C.

Article By
Ted Zangari
Sills Cummis & Gross P.C.
Federal Opportunity Zones Blog

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Wednesday, April 24, 2019

On April 17, the Internal Revenue Service ("IRS") issued new proposed regulations to address a number of the outstanding questions and ambiguities pertaining to the Opportunity Zone program. The hope is that the new IRS guidance will spur significant Opportunity Zone investments that have been on the sidelines waiting for additional clarity. The proposed regulations answer major questions regarding original use and substantial improvement of tangible property and vacant land, requirements for being considered a Qualified Opportunity Zone Business ("QOZB"), the treatment of leased property, income inclusion events and distributions, and how long a Qualified Opportunity Fund ("QOF") has to deploy capital in Qualified Opportunity Zone Property to satisfy the 90 percent asset test.

There are still outstanding issues and questions, including the tax treatment of interim gains of a QOF during an investor's holding period and QOF compliance reporting, to name a few. However, the IRS's most recent regulation proposal should facilitate additional activity and deal flow in the Opportunity Zone space. Here are a number of key highlights from the voluminous regulation release:

Real Estate Development

- The regulations specify that the original use and substantial improvement requirements do not apply to vacant land. Accordingly, any development of vacant property should qualify for QOF investment.

- Additionally, structures and buildings that have been vacant for 5 years will satisfy the original use requirement and will not require substantial improvements.

- For purposes of determining whether the substantial improvement requirements have been satisfied, property will be considered individually, asset-by-asset, as opposed to on an aggregate basis.

- In general, original use of property shall be deemed to commence when the property is placed in service in the Opportunity Zone for purposes of depreciation and amortization.

- Residential property development and management will constitute a QOZB involved in the active conduct of a business, but merely providing a triple-net lease to a lessee will not qualify.

- Where a property straddles an Opportunity Zone and non-Opportunity Zone area, the test for determining if the property is qualified will be based on the square footage being substantially located in the Opportunity Zone, with “substantially located” meaning that more of the property is in the zone than outside the zone based on the portion of unadjusted cost basis located in the Opportunity Zone.

Business Investments

- The regulations clarify the term “substantially all” in the context of QOF and QOZB requirements. A QOZB must have 70 percent of its owned or leased tangible personal property used in business maintained as qualified opportunity zone property as that term is defined in Internal Revenue Code (“IRC”) section 1400Z-2. In other contexts pertaining to a QOZB or QOF’s holding period of qualified opportunity zone property, the term “substantially all” means 90 percent. Finally, in the context of intangible property owned and used by a QOZB, the term “substantially all” means 40 percent.
- The proposed regulations also provide much-needed guidance pertaining to the 50 percent gross income requirement having been earned via active business conduct in the Opportunity Zone. The guidance provides the following safe harbors—
  - 50 percent of the services performed (based on hours) for the QOZB by its employees and independent contractors are performed within the Opportunity Zone;
  - 50 percent of the services performed for the QOZB by its employees and independent contractors are performed in the Opportunity Zone, as measured by amounts paid for the services performed;
  - The tangible property and management or operational functions of the QOZB in the Opportunity Zone are each necessary to generate 50 percent of the gross income of the QOZB.

If a QOZB cannot satisfy one of these safe harbor tests, there will be a facts and circumstances analysis that can be used to satisfy this gross income requirement.

Leased Property

- Leased tangible property may be treated as Qualified Opportunity Zone Property if the following criteria are satisfied:
    - The subject lease is entered into after December 31, 2017; and
    - “Substantially all” of the use of the leased property is in an Opportunity Zone during “substantially all” of the period for which the QOZB leases the property.
- The original use or substantial improvement requirements do not apply to leased property.
- Leased property may be acquired from a related party, but must satisfy the following criteria:
    - The lease must be a “market rate lease” (potentially relying on IRC section 482 concepts);
    - A QOF or QOZB may not make a prepayment to the lessor (or a person related to the lessor) relating to a period of use of the leased tangible property that exceeds 12 months.
    - The lessee becomes the owner of property that is Qualified Opportunity Zone Business Property with a value not less than the value of the leased personal property.
- The proposed regulations include an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property (other than unimproved land) that would have occurred for consideration that does not reflect market value.
- Leased tangible property may be valued using either an applicable financial statement valuation method (in accordance with GAAP) or an alternative valuation method, which calculates the present value of the lease payments for the use of the tangible property at the beginning of the lease period. The alternative method is fixed in time and does not reflect any depreciation or amortization.
- Improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property.

Qualified Fund’s Capital Deployment & Structure

- Failure to satisfy the 90 percent asset test during a testing period could result in penalties, but does not mean that the QOF is not a qualified fund.
- The proposed regulations allow a QOF to apply the 90 percent asset test without taking into account any investments received in the preceding 6 months if the new investments are held in cash, cash equivalents, or debt instruments with a term of 18 months or less.
- QOFs and QOZBs may elect to use the unadjusted cost basis to value tangible

property regardless of whether or not they have an applicable financial statement (they may also utilize the financial statement value as well).

- The regulation proposal permits a QOF to recycle the proceeds from the sale of Qualified Opportunity Zone Property into other Qualified Opportunity Zone Property provided the new investment occurs during the 12-month period beginning on the date of such distribution, sale, or disposition.

- However, the proposed regulations do not provide that the interim sale of Qualified Opportunity Zone Property during the Fund's life cycle is tax-free to investors/shareholders, even if the sale proceeds are recycled and reinvested into other Qualified Opportunity Zone Property.

- The proposed regulations also provide relief to investors in multi-asset QOFs that sell Qualified Opportunity Zone Property after 10 years. Investors who have held interests in a QOF for more than 10 years can make an election to exempt Fund-level gains passed through to them due to the Fund's sale of Qualified Opportunity Zone Business Property after 10 years. This provision is extremely helpful to facilitate fund managers organizing and managing multi-asset funds, but the exemption is not final and may not be relied upon until the provision is finalized by the IRS.

Working Capital Safe Harbor

- The first set of proposed regulations issued in October 2018 provided much-needed relief with the 31-month working capital safe harbor provided to QOZBs for the acquisition, construction and renovation of tangible property. The most recent IRS regulation proposal clarifies that this working capital safe harbor applies to the development of an operating business and is not limited to the renovation or construction of real estate.

- The proposed regulations provide that delays for government approvals will not cause a QOZB to run afoul of the 31-month working capital safe harbor.

- Additionally, the proposed regulations permit a QOZB to utilize multiple safe harbor periods relating to different investments made in the QOZB by a QOF.

Eligible Investors & Investments

- Eligible QOF investments only include cash or property; services are not eligible.

- For taxpayers that sell or dispose of assets used in their businesses, IRC section 1231 gains and losses must be netted and only the net amount may constitute an eligible investment in a QOF.

- The sale of property giving rise to the capital gain to be invested cannot be between the investor and the QOF entity in exchange for an eligible interest in the QOF.

- There are a number of inclusion events enumerated that would lead to recognition of deferred gains by an investor. These events include most transfers, including gifts (though a transfer to/from an estate due to a death is not considered an inclusion event).

- An inclusion event also involves a distribution of property or cash made by a QOF to an investor that exceeds the investor's basis in the QOF.

The regulation proposal includes a host of other rules and provisions, including broad anti-abuse powers provided to the IRS to guard against abusive transactions or those that are not in accord with the legislative intent surrounding the adoption of IRC 1400Z-1 & 1400Z-2. Finally, the IRS is also accepting feedback and input regarding compliance and investment reporting requirements for QOFs.

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