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Executive Summary: IRS Issues Second Installment of Qualified Opportunity Zone Fund (QOF) Proposed Regulations

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The following is a high-level executive summary of the material provisions of the second installment of qualified opportunity zone fund (QOF) Proposed Regulations (**New Proposed Regs**) issued by the IRS on April 17, 2019.[1] The New Proposed Regs amplify and clarify the first set of proposed regulations issued in October 2018 (**October Proposed Regs**).[2]

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The New Proposed Regs provide for the following:

1. Exit strategy/Disposition of Assets in Multi-Asset Vehicles.

In order to get the 10-year step-up in basis under the statute, an investor must sell an interest in the QOF. Under the October Proposed Regs and the New Proposed Regs, a single holding partnership may not form multiple QOFs. However, the New Proposed Regs provide some relief:

a. The New Proposed Regs propose (*but do not yet allow reliance upon*) the sensible solution to the multiple-property exit problem requested by the real estate industry that upon the sale by a QOF[3] of its property, (i) each investor owning its interest in the fund for 10 years may elect to exclude the capital gain passed through from the QOF and (ii) the basis of the QOF's assets are also stepped up (similar to a Section 754 election). ***Unfortunately, this provision expressly may not be relied upon by taxpayers until the New Proposed Regs are finalized*** (and it is therefore not yet helpful).

b. Interests in separate QOFs may be contributed into a partnership (**Parent Partnership**) without triggering the Deferred Gain. This Parent Partnership could serve as a pooled fund in which each of the separate QOFs may, after the 10-year holding period, sell its interest in subsidiary QOZBs with the step-up for the investors at that time. QOF program accountants and attorneys should be analyzing whether the open issues that still remain under this roll-up provision in the New Proposed Regs will prevent such roll-ups until further IRS guidance is issued.[4]

2. Financing Distributions are Possible.

The New Proposed Regs provide that distributions of loan proceeds may be made to investors in QOFs that are partnerships (but not REITs) without causing an "inclusion event" that triggers the Deferred Gain to the extent the distribution does not exceed the investor's basis in the investor's partnership interest. Under this new rule, refinancing distributions may be made to investors to pay investor tax on Deferred Gain when deferral ends in 2026 if the general partner determines that circumstances warrant at the time. However, distributions are subject to a presumption that if made within 24 months of the contribution, they are not dependent on the entrepreneurial risks of the QOF's business and thus the distributions would reduce the amount of the investor's eligible investment.

3. Deploying Capital/Working Capital.

The New Proposed Regs provide:

a. The semiannual 90% test for QOF assets does not take into account any capital contributions that have been made in the preceding six months, giving the QOF additional time to invest that money.[5]

b. Under the 31-month working capital safe harbor for QOF subsidiary JVs (each a QOZB), delays in the deployment of working capital caused by governmental action extend the QOZB's 31-month safe harbor period if the QOZB had made application for such governmental action within the 31-month period.

c. The 31-month working capital safe harbor is tracked separately and restarts with respect to each new QOF contribution from investors that is placed in the working capital reserve of the QOZB.

d. Assets may now be valued by using either a GAAP financial statement method or cost basis (previously, the GAAP financial statement method was compulsory for those who had GAAP financial statements).

4. Original Use vs Substantial Improvement Requirement.

Under the Internal Revenue Code and the October Proposed Regs, if property is "original use property," there is no requirement that substantial improvements (which at least double the cost basis of the property) be made. The New Proposed Regs clarify that:

a. If a partially constructed building has not been placed in service by anyone, it is original use property in the hands of an unrelated purchaser.

b. Improvements constructed on leased land are considered original use property.

c. A building previously placed in service becomes original use property if purchased after a five-year vacancy.

d. If a QOF acquires multiple assets, the QOF must satisfy the substantial improvement test on an asset-by-asset basis.[6]

5. Leased Property.

a. Leased tangible property is eligible for qualified opportunity zone business property (**QOZBP**) treatment in order to satisfy the "substantially all" thresholds if (i) it is acquired by lease after Dec. 31, 2017, and (ii) substantially all of its use is in a QOZ during substantially all of the period for which it is leased. Under the New Proposed Regs, 70% of the use of QOZBP must be in a QOZ during 90% of the holding period of the QOZBP by the QOF or QOZB.

b. Leased tangible property is not required to be "original use" or be subject to any substantial improvement requirements, but it must be leased at a market rate.

c. Tangible property may be leased from a related party if:

i. the QOF or QOZB does not at any time make a prepayment for a period longer than 12 months; and

ii. if the lease involves tangible personal property whose original use does not begin with the lessee, the leased personal property will not qualify as QOZBP unless the lessee also owns at least an equal amount of tangible QOZBP in the same or a substantially overlapping QOZ (and the lessee must own such property by no later than 30 months of possessing the leased property or by the end of the term of the leased property, whichever is earlier).

d. An anti-abuse provision prevents qualification of leases of real property (other than unimproved land) where there is an expectation that the real property will be acquired by the QOF for less than fair market value.

6. 1231 Gains as Eligible Deferred Gain.

Investors must net their year-end 1231 gains and 1231 losses from all sources and may not simply treat 1231 gain from a single K-1 as qualifying Deferred Gain until such netting has occurred. Therefore, the investor's 180-day period within which to invest such gain into a QOF begins at the end of his or her taxable year.

7. Gifts and Death Transfers.

a. Gifts cause a taxable "inclusion event" of the Deferred Gain, but transfers by death do not.

b. Upon death, the Deferred Gain is not eliminated for the heirs,[7] but the heirs are eligible for the same benefits as the decedent (e.g., no tax on future appreciation if the tacked holding period for the QOF interest exceeds 10 years, with the estate's holding period being added to the holding period of the decedent).

8. QOZ Straddles.

If a QOF acquires real property that is partially in a QOZ and partially outside the QOZ, and the real property outside of the QOZ is contiguous to the real property within the QOZ, all of the property will be treated as QOZ property if the square footage of the real property within the QOZ is "substantial" compared to the square footage of the real property outside the QOZ.[8]

9. Interim Sales.

a. For purposes of the semiannual 90% QOF asset test, a QOF that sells an asset but does not distribute the proceeds may hold the proceeds for up to 12 months without the proceeds being treated as non-qualified assets under the 90% asset test so long as the proceeds of the sale are held in cash or permitted short term debt.

b. If a QOF sells an asset prior to the 10-year holding period and reinvests the proceeds in QOZ property within 12 months of such sale:

i. the Deferred Gain continues to be deferred and no new holding period starts for 10-year testing, but

ii. investors will pay tax on the gain from the interim sale unless the new purchase in the zone is a section 1031 exchange.

10. Gross Income Test.

A QOZB must derive at least 50% of its gross income from the active conduct of a trade or business in a QOZ. The New Proposed Regs clarify that the leasing of real property used in a trade or business is treated as the active conduct of a trade or business, but a triple net lease of real property owned by a QOZB will not be considered the active conduct of a trade or business by the QOZB.

11. Carried Interest.

Special allocations, including where a partner receives a carried interest in exchange for services, will be treated as "mixed-fund" investments. Capital gains invested by a partner receiving a carried interest still remain eligible for QOZ tax benefits. However, the carried interest must be accounted for separately and *will not* be able to receive the QOZ tax benefits.[9]

12. Operating Businesses.

a. **Gross Income Test Safe Harbors**.The New Proposed Regs clarify how an operating business may satisfy the requirement that it derive at least 50% of its gross income from the active conduct of a trade or business in a QOZ by meeting any one of the following tests:

i. It may have at least 50% of the services performed (based on hours) for the business by its employees and independent contractors (and by the employees of independent contractors) performed within the QOZ; or

ii. It may have at least 50% of the services performed for the business by its employees and independent contractors (and by the employees of independent contractors) performed in the QOZ, based on amounts paid by the business to the employees and/or independent contractors for the services performed; or

iii. It may have a combination of the tangible property of the business that is located in a QOZ and the management or operational functions performed for the business in the QOZ that are each necessary to generate 50% of the gross income of the trade or business; or

iv. It may, based on a facts and circumstances test, derive at least 50% of its gross income from the active conduct of a trade or business in the QOZ.

b. Inventory in Transit. Substantially all of the use of a QOZB's property must be in a QOZ. The New Proposed Regs clarify that inventory will not fail to be considered to be used in the QOZ simply because the inventory is in transit from a vendor to the QOZB or from the QOZB to a customer.

c. Intangible Property. To qualify as a QOZB, a partnership or corporation must use a substantial portion of its intangible property in the active conduct of a trade or business in a QOZ. The New Proposed Regs have set the threshold for a “substantial portion” at a manageable 40% level.

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[1]For a deeper analysis of the technical aspects of the New Proposed Regs, see our Detailed GT Analysis of the New Proposed Regs, available here.

[2] The qualified opportunity zone (**QOZ**) program allows taxpayers to defer short-term or long-term capital gains tax due upon a sale or disposition of property in 2018 and future years if the capital gain portion of the sale or disposition (**Deferred Gain**) is reinvested within 180 days in a QOF. An investor who makes a qualifying investment in a QOF may receive the following three tax benefits:

i. the investor does not have to pay tax on the amount of the Deferred Gain that is invested in a QOF until the earlier of the occurrence of an inclusion event or Dec. 31, 2026;

ii. such Deferred Gain is reduced by up to 15% if the investment in the QOF is held for at least seven years; and

iii. the investor does not have to pay capital gain tax on the appreciation in its QOF interest if the interest in the QOF is held for at least 10 years.

3 It is not clear whether a QOZ business (**QOZB**) subsidiary of a QOF may take advantage of this election.

[4] The partnership documents of the QOF should be checked to see whether such a roll-up is permitted and the requirements to do so.

[5] This provision ***does not*** extend an investor’s 180-day period to invest in a QOF.

[6] The IRS is seeking comments regarding whether an aggregate approach may be appropriate.

[7] Instead, the gain is treated as income in respect of a decedent (IRD) when recognized in 2026 or earlier on an inclusion event.

[8] In the preamble to the New Proposed Regs, the IRS indicates that property located within the QOZ should be considered “substantial” if the unadjusted cost of the real property inside the QOZ is greater than the unadjusted cost of real property outside of the QOZ.

[9] If a sponsor both invests Deferred Gain and also receives a carried interest, the New Proposed Regs provide that the sponsor will have a mixed-funds investment, which shall be treated as two separate interests in the QOF, one a qualifying investment and the other a non-qualifying investment. In determining how to allocate the sponsor’s interest between the qualifying and the nonqualifying interests, the Preamble to the New Proposed Regs provides that the highest percentage share of a variable carried interest of a service partner is the percentage of such partner’s aggregate distributions that will be treated as ineligible for QOZ benefits. Accordingly, to avoid having a mixed-funds investment, a sponsor may consider segregating its carried interest in a separate entity (such as the general partner entity) from the entity through which the sponsor makes contributions of Deferred Gain (such as through an affiliated limited partner). Sponsors should consult with tax advisors on optimal entity structuring for profits interests in a QOF.

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