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CLIENT ALERT

Proposed Opportunity Zone Fund Regulations Provide Helpful Guidance to Taxpayers

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On April 17, 2019, the Internal Revenue Service (the "IRS") and the Treasury Department issued proposed regulations (the "Proposed Regulations") providing additional guidance regarding the investments in "qualified opportunity funds" (individually, a "QOF").

New tax incentives for investments in QOFs were originally added by the Tax Cuts and Jobs Act in 2017 in order to encourage long-term private investment in low-income communities. On October 19, 2018, the IRS and Treasury Department issued an initial set of proposed regulations that clarified certain issues regarding QOFs but left many questions unanswered. The Proposed Regulations further clarify existing statutory language, provide additional flexibility for investors, and make it easier for QOFs to ensure compliance with requirements that 90% of the QOF's assets are invested in qualified opportunity zone property. Some highlights of the Proposed Regulations are outlined below. The full text of the Proposed Regulations can be found here.

QOFs. The Proposed Regulations generally provide clarity with respect to how QOFs can satisfy the applicable qualification requirements.

- *90% Asset Test*. A QOF must hold at least 90% of its assets in certain qualified opportunity zone property, as measured on the last day of the first six-month period of the tax year of the QOF and the last day of the tax year of the QOF. The Proposed Regulations provide additional flexibility to existing QOFs that receive new capital shortly before the semi-annual test by allowing a QOF to apply the 90%-test without taking into account any cash, cash equivalents, or short-term debt instruments that were received by the QOF in the preceding six months.
- *Asset-by-Asset Sales, But No Gain Rollover*. If a QOF sells an asset that constituted qualified opportunity zone property, the Proposed Regulations provide that any proceeds from such sale will constitute qualified property so long as such proceeds are reinvested in other qualified opportunity zone property within 12 months of the sale. However, the Proposed Regulations do not provide any means of structuring any such sale in a tax-deferred manner, i.e., a QOF cannot roll over the gains from the sale of qualified opportunity zone property into another qualified opportunity zone property in a tax-deferred manner.
- *Qualified Opportunity Zone Business Property*. Earlier proposed regulations had provided that 70% of the assets of a qualified opportunity zone business had to be qualified opportunity zone business property. The Proposed

Regulations further clarify that this requirement is satisfied if at least 70% of qualified opportunity zone business property (whether owned or leased) is used in a qualified opportunity zone.

- *Treatment of Leased Property*. The Proposed Regulations explain that, unlike owned property, leased property is not subject to the original use requirement, need not be substantially improved by the lessee, and may be acquired from a related party. However, in lieu of such requirements, the Proposed Regulations require both that the underlying lease constitute a "market rate lease" and impose certain other limitations upon leased property acquired from a related person. These rules are generally taxpayer-favorable.
- *Active Trade or Business Requirement—Investments in Operating Businesses*. The Proposed Regulations provide much-needed guidance on when a QOF can invest in an operating business. In order to qualify as a "qualified business entity," a corporation or partnership must (in addition to other requirements) derive at least 50% of its income from the "active conduct of such business." The Proposed Regulations provide three safe harbors and one "facts and circumstances" test for how a business can satisfy this threshold and demonstrate the application of the safe harbors through two illustrative examples. The safe harbors measure hours worked, amounts paid for services performed, and share of tangible property used and management or operational functions performed within the opportunity zone. The fourth "facts-and-circumstances" test measures whether at least 50 percent of the gross income of a trade or business derives from the active conduct of the qualified opportunity zone business within the opportunity zone. The proposed safe harbors are a positive development for investors and businesses because they allow for more flexibility as compared to the rigid test in the original legislation. However, merely entering into a triple-net-lease does not satisfy the active conduct requirement.
- *Unimproved Land.* The Proposed Regulations provide that, subject to limited exceptions, unimproved land purchased in a qualified opportunity zone generally is not required to be substantially improved.

Investors in QOFs. The Proposed Regulations generally provide additional flexibility for QOFs but not for fund sponsors receiving carried interest.

- *Inclusion of Gain*. The amount of gain that is deferred with respect to a qualifying investment generally must be included in the investor's income in the taxable year that includes the earlier of (i) the date on which such qualifying investment is sold or exchanged, or (ii) December 31, 2026. The Proposed Regulations provide an expansive list of the transactions that constitute inclusion events under the preceding clause (i). In general, while certain tax-deferred transactions are inclusion events, a tax-deferred contribution to a partnership pursuant to Section 721 of the Code is *not* an inclusion event.
- *Investments of Property.* The Proposed Regulations allow investors to acquire interests in QOFs in exchange for contributions of non-cash property. In such instances, the amount considered invested in the QOF generally will be the lesser of the tax basis in the property and its fair market value as of the date of the contribution.
- *Transfers at Death*. The Proposed Regulations clarify that neither (i) the transfer of a qualifying investment to the owner's estate nor (ii) the distribution by an estate to a decedent's legatee or heir is an inclusion event.
- *Leveraged Distribution by QOF Formed as a Partnership.* The Proposed Regulations provide a favorable rule on how a borrowing by a QOF is treated with respect to an investor. An investor can include in his or her tax basis in a QOF a share of the debt in a QOF and can receive a distribution of refinancing proceeds from a QOF without triggering gain or losing benefits of these provisions, as long as the distribution does not exceed the basis. These favorable rules do not apply to distributions by a QOF within two years of an investor's investment in a QOF.
- *Exit Through Sale of Assets*. The QOF rules enacted by Congress generally provide for a complete exclusion from income of gain on the sale of a QOF if the interest in the QOF was held for at least 10 years. The Proposed Regulations extend this rule to gain from the sale of qualified opportunity zone property by a QOF that is a partnership, S corporation, or REIT if such sale occurs after the taxpayer's 10-year holding period requirement has been satisfied. Accordingly, the Proposed Regulations provide flexibility for such QOFs to structure exits as asset sales, rather than as sales of equity interests in such QOFs.
- *Carried Interest*. The Proposed Regulations explain that any interest in a QOF that is received in exchange for services rendered to the QOF is a non-qualifying investment. This provision should not affect interests acquired

by QOF sponsors in exchange for cash, but appears to affect carried interest and profit interest acquired with waived management fees.

The IRS and the Treasury Department have requested that taxpayers submit any relevant comments to the Proposed Regulations within 60 days after the publication of the Proposed Regulations in the Federal Register. In addition, the IRS and the Treasury Department intend to issue future guidance with respect to information reporting requirements and the penalty under Section 1400Z-2(f) of the Code pertaining to a QOF's failure to satisfy the 90% asset test.

Please see our prior client alert, "Opportunity Zone Funds Provide Fund Managers with a New Zone of Opportunity," here.
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