Treasury Releases Second Round of Guidance on Qualified Opportunity Zones

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P.L. 115-97 includes a new tax incentive program designed to encourage investment in low income communities designated by the Treasury Department as Qualified Opportunity Zones (QOZs). QOZ financing is channeled through a Qualified Opportunity Fund (QOF) which provides taxpayers three incentives:

i. Deferment of tax liability on capital gain realized from the sale or exchange of appreciated assets;
ii. A permanent exclusion from taxation for up to 15% of the originally deferred gain; and
iii. For taxpayers that maintain their investments in the QOF for at least ten years, a permanent exclusion from taxation for any appreciation in excess of the deferred gain.

On April 17, 2019, Treasury released new proposed regulations which have the effect of supplementing and revising the proposed regulations issued in October of 2018. These new proposed regulations clarify a number of issues and leave some questions unanswered.

These new proposed regulations might be usefully examined in two parts, First, we will consider the guidance they offer for qualified Opportunity Zone Businesses. Next, we will review their proposed rules for Qualified Opportunity Zone Business Property (QOZBP).

I. Requirements for QOZ Businesses.

To qualify as a QOF, a fund must have at least 90% of its assets invested in QOZ property. QOZ property includes stock in a corporation and an equity investment in a partnership if the corporation or partnership is organized for the purpose of being a Qualified Opportunity Zone Business (QOZB).

Generally, for a trade of business to be a QOZB, it must meet five tests:

i. At least 70% of the tangible property owned or leased by the business must be QOZBP
ii. At least 50% of the gross income of the business must be derived from the active conduct of a trade or business[1] in a QOZ

[1] N.B. the term "trade or business," while used throughout the Internal Revenue code and associated regulations, remains undefined for purposes of the tax law.

iii. A substantial portion of the intangible property of the business must be used in the active conduct of the trade or business in the QOZ;
iv. Less than 5% of the average of the aggregate unadjusted basis of the property of the business may be from financial assets; and
v. The business must not be one of the enumerated prohibited businesses[2]

We will consider the guidance provided by the April 2019 proposed regulations regarding each of these tests.

70 Percent of Tangible Property Test

This test is measured as a fraction, the numerator of which is the total value of all tangible QOZBP owned or leased by the business and the denominator of which is the value of all tangible property owned or leased by the business.

For purposes of this test, a taxpayer may use either of two methods to value the subject property:

- Taxpayers with or without audited financial statements (or financial statements required to the filed with the SEC (or specified other federal agencies) may use the value of the property that is (or would be) reported on their financial statements; or
- Taxpayers may use the unadjusted cost basis of the tangible property owned by the business and use a present value method for tangible property leased by the business. Taxpayers without audited financial statements will use this second method.

In some circumstances outside the scope of these notes, a taxpayer may utilize the valuation method that is used for determining compliance with the 90% of assets requirement, referenced above.

50% of Gross Income Test

The April proposed regulations provide three safe harbors and a facts-and-circumstances test that can be used to evaluate meeting the 50% gross income test.

The three safe harbors include:

- *Hours of Work.* A business may rely on this safe harbor if at least 50% of the total hours of services performed by its employees, independent contractors, and employees of its independent contractors during the taxable year are performed within the opportunity zone
- *Cost of Services.* This safe harbor is available to a business whose total amount paid for services performed by its employees, independent contractors, and employees of its independent contractors during the taxable year performed within the opportunity zone is at least 50% of the total cost of services

[2] These include the conduct of (including the provision of land for) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. *See*, 26 U.S.C. §144(c)(6)(B)

- *Business Functions and Tangible Property.* A business may use this safe harbor if the management and operations performed in the opportunity zone *and* the tangible property located in the opportunity zone are each needed to produce 50% or more of the gross income of the trade or business

The facts and circumstances test requires the business to demonstrate that 50% or more of its gross income is generated by the active conduct of a trade or business in the qualified opportunity zone.

It is possible in limited circumstances for income produced outside the opportunity zone to be counted toward the 50% gross income test. When the opportunity zone and the non-opportunity zone property are contiguous parcels and the square footage of the operations within the opportunity zone is substantial related to the non-opportunity zone property, the non-opportunity zone property will be treated as if it is QOZ property for purposes of both:

- The 50% gross income location test; and
- The substantial use of intangible property test (see below). The April 2019 proposed regulations do not adopt this rule for purposes of the 70% qualified opportunity zone business property test

Substantial Use of Intangible Property

This test requires a QOZ business to use a substantial portion of its intangible property (such as patents or copyrights) in the active conduct of its trade or business within the QOZ.

The new proposed regulations provide that the substantial use requirement for intangible property is met if 40% or more of the intangible property of the business is used in the QOZ in connection with the active conduct of a trade or business. As observed above, the use of intangible property in a non-QOZ parcel contiguous to a QOZ can count toward the 40% test.

The April 2019 proposed regulations do not provide any definition for the active conduct of a trade or business. They do, however, state that the ownership and operation, to include leasing or real property does, for purposes of the QOZ statute, constitute the active conduct of a trade or business insofar as the activity involves more than simply entering triple net leases with respect to the property.

5 percent Financial Assets Test

A QOZ property must have 5% or less of the unadjusted basis of its property be attributable to financial assets. For the purpose of this test, a reasonable amount of working capital held in cash (or cash equivalents) for less than 18 months will not be included in the measure of financial assets.

The April 2019 proposed regulation modify the safe harbor originally described in the October 2018 regulations. As modified, the amount of working capital is within the safe harbor if three tests are met:

- The amounts of working capital is described in writing for the development of a trade of business within a QOZ;
- There exists a written schedule produced for the use of the funds within 31 months after receipt of the working capital; and
- The working capital is actually used in a matter substantially consistent with both the written description and the schedule described above

Delays caused by dilatory government action (e,g delays in issuance of necessary permits) will not cause the business to fail the test. The April proposed regulations also provide that a business may apply the safe harbor more than once, such as for subsequent rounds of capital finding, so long as the above tests are met.

II. Requirements for Opportunity Zone Business Property

The new proposed regulations describe rules for property to qualify as QOZBP. These rules effectively involve three tests:

i. The property must be tangible property acquired by the business from an unrelated party or leased after December 31, 2017;
ii. Original use or substantial improvement requirements are met; and
iii. During at least 90% of the holding period for the tangible property, at least 70% off the use of the tangible property must be in a QOZ

For leased property, the requirements vary. Five general requirements apply to leased property for it to be qualified as QOZBP:

i. The lease must have been entered into December 31, 2017
ii. The terms of the lease must be arms-length market terms and the rate must be a market rate
iii. With leased property, the lessor can be a related party, but two other requirements then attach to the transaction. First, the lessee may not make any prepayment in connection with the lease relating to a period of use of the property that exceeds 12 months.[3] Second, if the related-party lease is of tangible personal property and if the original use of the leased tangible personal property does not commence with the lessee, the leased tangible personal property is not QOZ Business Property unless the lessee becomes the owner of other tangible property that is QOZ Business Property having a value at least equal to the value of that leased tangible personal property within a specified "relevant testing period" and there is "substantial overlap" of the QOZs in which the owner of the other tangible property so acquired uses it and the QOZs in which that owner uses the leased tangible personal property [4]
iv. In a situation involving leased real property, there may be no plan or expectation for the business to purchase the leased property for other than its fair market value

[3] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(i)(B)(4); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i)(B)(4)

[4] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(i)(B)(5); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i)(B)(5). "Relevant testing period" is defined in § 1.1400Z2(d)-1(c)(4)(i)(B)(7) and § 1.1400Z2(d)-1(d)(2)(i)(B)(7) as the period that begins on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on the earlier of—the date 30-months after the date the lessee receives possession of the property under the lease; or the last day of the term of the lease. "Substantial overlap" is currently not defined in the available guidance.

The proposed rules concerning the "original use" of the property consider a variety of scenarios.

- In the case of leased tangible property, the original use, for purposes of depreciation, commences on the first date the leased property is placed in service in the QOZ
- When the business is using leased or owned property that has been unused or vacant for an uninterrupted period of at least five years, the original use commences on the date after that period of disuse or vacancy when the property is placed in service
- Acquired used tangible property satisfies the original use requirement if the property has not been previously used in the QOZ
- Special rules allow tangible personal property that does not otherwise meet the original use test to count as original use property if the lessee becomes the owner of tangible personal property that is QOZBP with a value at least as much as the subject leased tangible personal property, and other requirements are met [5]

The April 2019 proposed regulations clearly articulate that the land within a QOZ need not be substantially improved. The land can qualify as QOZBP so long as its condition is usual in the trade or business of either the QOF or the QOZB. A QOF may not rely on this provision, however, until the proposed regulations become final in cases where both the following circumstances exist:

- The land is unimproved or minimally improved; and
- The QOF or QOZB purchases the land with an expectation, and intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase

In response to requests by the real estate industry, the New Proposed Regs propose (but do not yet allow reliance upon) the solution to the multiple-property exit problem that upon the sale by a QOF 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).[6]

Finally, the new proposed regulations provide that the 70% test may be met with inventory in transit to a QOZ or from a QOZ to a customer.

While the April 2019 proposed regulations are not yet final, taxpayers may begin relying on them now (with exceptions as noted above and in the text of the October 2018 and April 2019 proposed regulations) so long as taxpayers consistently apply both the October 2018 and the April 2019 proposed regulations in their entirety.

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These notes are intended only as illustrations of general principles and are not legal or tax advice. The reader is cautioned to discuss his or her specific circumstances with a qualified practitioner before taking any action.

[5] See n. 4, *supra,* and accompanying text.

[6] Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii). If section 1231 property is disposed of, the taxpayer can make the Gain Exclusion Election only with respect to capital gain net income from section 1231 property to the extent of net gains determined under section 1231(a) reported on Schedule K-1 of the QOF Partnership or S Corporation.