Updated FAQs on the Second Round of Proposed Opportunity Zones Regulations

This resource is for informational and educational purposes only. It is not intended to constitute legal or professional advice and should not be relied upon or treated as a substitute for consultations with professional, legal, or other competent advisers.

Interim Gains:

- How do the regulations address interim gains from the sale or disposition of an asset before the completion of the 10-year holding period?

There are three potential negative consequences from an interim sale or disposition of an asset before the end of the 10-year holding period: (1) it could trigger the investor's deferred gain; (2) the flow-through of such gain from an Opportunity Fund partnership could result in tax liability to the investor; and (3) the proceeds from the sale could cause the Opportunity Fund not to satisfy the 90% asset test. The proposed regulations respond to all three.

The proposed regulations provide that recognition of interim gain, in and of itself, does not trigger an inclusion event that would cause the investors to prematurely recognize the gain that they initially deferred in making an investment into the Opportunity Fund.

However, the preamble to the proposed regulations clarifies that interim gains will be subject to tax under ordinary tax rules. For example, if an Opportunity Fund that is treated as a partnership for tax purposes realizes an interim gain, the investor's distributive share of this gain will be subject to tax (even if the investor does not receive any cash from the fund). Although not explicitly addressed in the proposed regulations, it appears that, prior to 2027, an investor that receives an interim capital (but not ordinary) gain may further defer recognition of this gain until no later than December 31, 2026 by reinvesting the amount of gain into the same or another Opportunity Fund. This will be a new investment with a new holding period for purposes of the qualified opportunity zone benefits.

Finally, the proposed regulations permit the Opportunity Fund to treat the proceeds of the interim sale as qualified opportunity zone property for purposes of its 90% asset test if the proceeds from sale are held in in cash, cash equivalents, or short-term debt, and they are reinvested within 12 months in qualified opportunity zone property. This should help the fund avoid being penalized for the interim sale.

- What does this mean in practice for selling the underlying business assets of the qualified opportunity zone business (e.g., the real estate) and distributing the sale proceeds in liquidation of the business versus selling the Opportunity Fund's equity interests in the qualified opportunity zone business?

As a practical matter, there should generally be little difference, as both are assets owned (directly or indirectly) by the Opportunity Fund. Any gain will be recognized by the entity selling the asset—the qualified opportunity zone business if it sells the underlying asset, or the Opportunity Fund if it sells the interest in the qualified opportunity zone business.

- Additionally, what does this mean in practice for Opportunity Funds or qualified opportunity zone businesses incorporated as corporations versus partnerships?

If a fund is treated as a partnership for tax purposes, interim items of income, loss, deduction, and credit will be allocated to each investor under ordinary partnership tax principles. Deductions and losses may only be taken by investors to the extent they have basis in their partnership interest. Because of the "zero basis" rule, investors in an Opportunity Fund generally will have a lower basis than investors in a typical investment fund, and the ability of investors to use deductions and losses may be more limited as a result. Although the investor's basis in the Opportunity Fund partnership starts at zero, it can be increased by the investor's allocable share of the partnership's debt (in addition to the five and seven-year basis step-ups and basis for ordinary operating income). Thus, many funds will use debt to unlock these tax benefits for investors. However, distributions in excess of basis are inclusion events, so the amount of debt will need to be managed by funds and their sponsors to avoid inclusion events. If the qualified opportunity zone business is also a partnership, its items will flow through to the Opportunity Fund, which in turn, will flow through to the investors.

If a fund is treated as a corporation (other than a REIT), the fund itself will generally pay taxes on its net taxable income. Similarly, if the qualified opportunity zone business is a corporation, it (and not the Opportunity Fund) will generally pay taxes on its net taxable income. Either way, investors will not report Opportunity Fund corporation taxable income on their personal income tax returns.

Definitions:

- What is the definition of "active conduct of a trade or business?" Do triple-net leases fall under this definition?

The proposed regulations define a "trade or business" by reference to the provision allowing deductions for ordinary and necessary business expenses, which is a factual determination governed by a large body of case law. The proposed regulations provide limited guidance on the meaning of "active conduct" of a trade or business, providing only that the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, they do state that "merely entering into a triple-net-lease" with respect to real property owned by a taxpayer is not the active conduct of a trade or business. The proposed regulations do not provide any other guidance on the scope of "active conduct," including activities other than leasing, leases of personal property, or activities involving the management of a high volume of triple-net leases.

- How do the regulations define the many references to "substantially all" throughout the statute?

The statute creates four distinct "substantially all" tests. The first test is used in determining whether an equity interest held by an Opportunity Fund is a good asset for purposes of the Opportunity Fund's 90% asset test. The second set of proposed regulations defines substantially all in this context of at least 90%. In practice this means that the entity in which the equity interest is held must remain a qualifying opportunity zone business "during *substantially all* [at least 90%] of the qualified opportunity fund's holding period."

The second test is used to determine whether an entity owned by an Opportunity Fund qualifies as a qualified opportunity zone business: "a trade or business in which *substantially all* of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property." This use of substantially all was defined in the first set of proposed regulations to mean at least 70%.

The third and fourth tests are used to determine whether property held by the Opportunity Fund or qualified opportunity zone business is qualified opportunity zone business property. The provision contains a compound use of the term "substantially all": "during *substantially all* of the qualified opportunity fund's holding period for such property, *substantially all* of the use of such property was in a qualified opportunity zone."

The proposed regulations define substantially all as it relates to an Opportunity Fund's holding period to mean at least 90% and as it relates to use to mean at least 70%.

- How did the regulations define "original use" as it relates to vacant property?

The proposed regulations provide that if property has been unused or vacant for an uninterrupted period of at least five years, use of that property in the Opportunity Zone qualifies as original use.

Property that Straddles Census Tracts:

- How do the regulations qualify property that straddles two contiguous census tracts: one that is a designated Opportunity Zone and one that is not?

For businesses that have real property located within an Opportunity Zone that is contiguous to real property located outside the Opportunity Zone, all of the property is deemed to be within the Opportunity Zone if the amount of real property within the Opportunity Zone, based on square footage, is substantial as compared to the amount of square footage of real property located outside the zone. However, this proposed rule can be read to treat the property as being entirely in the Opportunity Zone only for certain requirements, such as the 50% gross income test. For other requirements where the census tract straddle rule does not apply, such as whether the real property meets the 70% use test or is treated as qualified opportunity zone business property, the rule can be read that only that part of the property that is in the Opportunity Zone will count.

50% Gross Income Test:

- Did the regulations offer additional flexibility for businesses to meet the 50% gross income test?

Yes. Although the second set of proposed regulations retain the requirement that at least 50% of the gross income of the business is derived in the Opportunity Zone, the regulations adopt three safe harbors and a facts and circumstances test for meeting this requirement. The Qualified Opportunity Zone Business may meet the gross income test through satisfying one of the safe harbors:

- At least 50% of the services performed by employees or independent contractors (based on hours) are performed in the Opportunity Zone;
- At least 50% of the amount paid for services are for services performed by employees or independent contractors in the Opportunity Zone; or
- The tangible property and management and operational functions needed to produce 50% of gross income are located in the Opportunity Zone.

To the extent the Opportunity Zone Business does not meet any of the safe harbors, the gross income test may still be met based on facts and circumstances that show at least 50% of the Opportunity Zone Business's gross income is derived from the active conduct of a trade or business in the Opportunity Zone.

Timing Flexibility:

- How do the regulations provide additional timing flexibility for a Qualified Opportunity Fund's initial deployment of capital?

The proposed regulations provide that for purposes of meeting the 90% asset test on a testing date, the Opportunity Fund may choose not to take into account any investments received within the last six months that are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. This effectively gives Opportunity Funds a minimum of six months and up to a year to deploy newly received capital. For example, if a calendar year Opportunity Fund receives cash from an investor in August 2019, it's first testing date would be December 31, 2019. However, the Opportunity Fund may disregard the cash for six months (until February 2020) and thus is not required to count it until the next testing date, June 30, 2020.
Fund Exits:

- Do the regulations provide additional flexibility for Qualified Opportunity Funds to dispose of fund assets, beyond investors selling their interests in the QOF after the 10-year holding period?

Yes. If an investor holds his or her interest in an Opportunity Fund for at least 10 years, the investor can elect to step up the basis in the fund to its fair market value, which allows the investor to exclude gain attributable to the appreciation. The statute suggests that this election is only available if the investor sells the interest in the Opportunity Fund. The proposed regulations extend this benefit to allow the investor to exclude from income his or her share of capital gain from the disposition of qualified opportunity zone property that the Opportunity Fund reports to the investor on a Schedule K–1 (the "K-1 rule"). It is not clear, however, whether the K-1 rule applies to dispositions of property by a qualified opportunity zone business, as the proposed regulations only mention dispositions by Opportunity Funds. In addition, it appears that the K-1 rule cannot be used to exclude ordinary income, such as that produced by the sale of "hot assets." Hot assets are assets that if sold by a partnership, will generate ordinary income rather than capital income. Examples include inventory, unrealized receivables, and personal property depreciation recapture.

When an investor sells her interest in an Opportunity Fund partnership, and makes a 10 year fair market value basis adjustment election, another rule in the proposed regulations appears to require an Opportunity Fund partnership to step up the basis of the fund partnership assets to fair market value, which has the effect of eliminating income from the Opportunity Fund's hot assets. However, this rule does not apply if the Opportunity Fund sells underlying assets under the K-1 rule. Thus, there appears to be a discrepancy between disposing of the assets or interests in the Opportunity Fund as it relates to recognition of ordinary income with respect to hot assets.

- Can this section of the proposed guidance be relied upon until the rules are finalized?

The preamble of the regulations provides that taxpayers may generally rely on the proposed rules, with the exception of guidance relating to the 10-year basis step-up, because those rules do not apply until January 1, 2028.

Expanded Definition of Working Capital Safe Harbor:

- Does the safe harbor apply towards any use of funds towards operations, or is it still limited to the acquisition of tangible property?

The proposed regulations provide that the working capital safe harbor now includes the development of a trade or business in a Opportunity Zone, as well as acquisition, construction, and/or substantial improvement of tangible property, thus extending it to operating businesses. The regulations provide additional flexibility by stating that exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action, such as granting a permit, if the application for that action is completed during the 31-month period. Finally, the regulations provide that a single qualified opportunity zone business may benefit from multiple overlapping or sequential applications of the working capital safe harbor to different infusions of capital. However, the examples appear to suggest that a "cliff effect" still exists if no trade or business exists at the end of the first 31-month period.

1231 Gains:

- How do the regulations treat section 1231 gains, with respect to the start of the 180-day investment period?

The proposed regulations provide clarity that net section 1231 gains qualify as capital gains eligible for deferral. However, since a taxpayer must wait until the end of the year to compute the net section 1231 gain or loss, the proposed regulations provide that the 180-day period for net section 1231 gains begins on the last day of the taxable year. This could be a trap for the unwary, as it could create an artificial waiting period for investors who would otherwise invest their gains shortly after they are realized in order to maximize their benefit. Net section 1231 gains, such as those generated by the sale of depreciable property and real property used in a trade or business and held for more than one year, are an important category of capital gains for many business owners.

Leased Property:

- Do the regulations treat leased property and the business of leasing as qualified investments?

The proposed regulations treat leased property, even property leased from a related party, as qualified opportunity zone business property if it satisfies certain requirements. In order to qualify, leased property must be acquired by the Opportunity Fund or qualified opportunity zone business under a lease entered into after December 31, 2017. As with owned property, at least 70% of the use of the leased tangible property must be in a qualified opportunity zone during at least 90% of the period for which the business leases the property. The lease must be a "market rate lease" that reflects common, arms-length market practice in the locale that includes the qualified opportunity zone. This is a particularly important clarification for tribal communities whose land is often leased from the U.S. government.

Additional rules apply with respect to related-party leases. First, the lessee cannot prepay more than 12 months' rent. Second, if the original use of leased tangible personal property does not commence with the lessee, the proposed regulations require that the lessee acquire qualified opportunity zone business property with a value not less than the value of the leased personal property within 30 months, a rule analogous to the substantial improvement requirement for owned property.

Finally, 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). Under this rule, there cannot be a plan for the real property to be purchased by an Opportunity Fund or qualified opportunity zone business for an amount other than the fair market value of the real property at the time of the purchase (without regard to any prior lease payments).

The proposed regulations provide additional favorable rules for leased property that is treated as qualified opportunity zone business property. For example, the proposed regulations do not impose an original use or substantial improvement requirement for leased property, and leasehold improvements are treated as meeting the original use test.

Carried Interest:

- How does the "services" test in the regulations apply to carried interest?

The proposed regulations provide that an interest in an Opportunity Fund received in exchange for services rendered to the Opportunity Fund (or certain other persons, such as qualified opportunity zone businesses owned by the Opportunity Fund) will not be a qualifying interest under the opportunity zone rules. This rule should prevent a typical carried interest in an Opportunity Fund from being treated as a qualifying investment. An investor can contribute services to an Opportunity Fund in exchange for a non-qualifying investment that does not receive the opportunity zone tax benefits while also contributing cash or other property in exchange for a qualifying interest.

Guardrails/Anti-Abuse Provisions:

- What guardrails did Treasury introduce or strengthen in this round of regulations?

The second set of proposed regulations sets up a number of new guardrails and anti-abuse measures.

First, the proposed regulations create a general anti-abuse provision that allows the IRS to recast a transaction that otherwise would qualify for the opportunity zone tax benefits if a significant purpose of the transaction is to achieve a result inconsistent with the purposes of the legislation. This general anti-abuse provision would be a powerful tool for the IRS to combat abuse, but it also increases investor uncertainty because no guidance has yet been provided regarding when it would be applied.

Second, the proposed regulations provide an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property. Under this rule, there cannot be a plan for leased real property to be purchased by an Opportunity Fund or qualified opportunity zone business for an amount other than the fair market value of the real property at the time of the purchase (without regard to any prior lease payments).

Third, taxpayers are not permitted to rely on favorable rules for substantial improvement of unimproved land in situations where the land is purchased with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase. This provision appears to be targeted primarily at "land banking" practices where undeveloped land is purchased with a view to sell the land at a profit when it has been approved for development.

Finally, the proposed regulations provide that deferred gain will be triggered by certain distributions of property to a partner of an Opportunity Fund partnership and expand the way in which the partnership "disguised sale" rules apply in the context of an Opportunity Fund partnership. These rules appear to be intended to prevent potentially abusive transactions in which investors attempt to effectively cash out their investments early.

Reporting Requirements:

- How did Treasury and IRS address data collection and reporting requirements in the second round of regulations?

Treasury released a Request for Information (RFI) on reporting requirements. The RFI announced two anticipated changes to the Form 8996 to require additional reporting: Employer Identification Number (EIN) of the qualified opportunity zone business, and Amount invested located in particular census tracts. The addition of the EIN is important, as that data would unlock substantial amounts of linked information about qualified opportunity zone businesses.

The RFI requests comments on additional information that would be helpful for tracking effectiveness of the incentive, ensuring investments in QOZs remain an attractive option, and the costs and benefits of various methods of collecting information. Comments on this RFI were due May 31. Here is the EIG Opportunity Zones Coalition's response.