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Additional Proposed Regulations Issued Regarding Opportunity Zones

As part of the US federal tax reform in 2017, Congress enacted sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "Code"), to provide incentives economic growth and investment in designated distressed communities known as Qualified Opportunity Zones (QOZ). Pursuant to this incentive program, taxpayers who invest capital in designated QOZs through qualified investment vehicles may receive significant tax benefits that include 1) deferral of tax for capital gains from an unrelated investment that is invested in a Qualified Opportunity Fund (QOF) until 2026; 2) elimination of 15 percent of the tax on the capital gains that are invested in a QOF if the QOF investment is held for at least seven years (or 10 percent of the tax on the capital gains that are invested in a QOF for at least five years); and 3) elimination of tax on the appreciation on a QOF investment upon exiting a QOF if the QOF investment is held for at least 10 years.

On April 17, the IRS and Treasury released the second set of proposed regulations relating to the QOZ program (the "Proposed Regulations"). Katten's summary of the first set of proposed regulations, which were released on October 19, 2018 (the "Initial Proposed Regulations"), is available at "Qualified Opportunity Zone Proposed Regulations Q&As." The Proposed Regulations clarify several important issues within the QOZ program, summarized below. The full text of the Proposed Regulations is available here. Please contact one of the members of Katten's Opportunity Zone Working Group for further information.

Qualified Opportunity Zone Business Requirements

In order for a corporation or partnership to qualify as a qualified opportunity zone business, at least 50 percent of its total gross income for each taxable year must be from the active conduct of a business within a QOZ. An area of concern has been how the Treasury and the IRS will determine if this 50 percent gross income requirement is satisfied. The Proposed Regulations provide three safe harbors and a facts and circumstances test for determining whether sufficient income is derived from a trade or business in a QOZ.

First, a trade or business meets the 50 percent gross income requirement if at least 50 percent of the services performed (based on hours) for such business by its employees and independent contractors (and employees of independent contractors) are performed within the QOZ. Second, a trade or business meets the 50 percent gross income requirement if at least 50 percent of the services performed (based on amounts paid for the services performed) for the trade or business are performed in the QOZ. Third, a trade or business meets the 50 percent gross income requirement if the tangible

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property of the trade or business located in a QOZ and the management or operational functions performed in the QOZ are each necessary for the generation of at least 50 percent of the gross income of the trade or business. Finally, a trade or business meets the 50 percent gross income requirement if, based on all the facts and circumstances, at least 50 percent of the gross income of a qualified opportunity zone business is derived from the active conduct of a trade or business in the QOZ.

Commentators had raised questions regarding the application of the requirements to be a qualified opportunity zone business (including the foregoing safe harbors relating to the 50 percent gross income requirement) when the relevant business holds real property straddling multiple census tracts and not all of the tracts are designated as a QOZ. For purposes of determining where services, tangible property or business functions are located in applying the requirements for being a qualified opportunity zone business, the Proposed Regulations allow businesses to treat all their real property as being deemed to be located within a QOZ, provided that the amount of real property located within the QOZ (based on square footage) is substantial as compared to the amount of real property outside of the QOZ (based on square footage), and the real property outside of the QOZ is contiguous to part or all of the real property located inside the QOZ.

Working Capital Safe Harbor

In order to be treated as a qualified opportunity zone business, the statute generally provides that less than 5 percent of the average of the aggregate unadjusted bases of the assets of the business must be attributable to "nonqualified financial property." For these purposes, the Initial Proposed Regulations provided a safe harbor for reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less. Under this safe harbor, working capital assets are treated as reasonable in amount if the amounts are designated in writing for the acquisition, construction and/or substantial improvement of tangible property in a QOZ, there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets that calls for the working capital assets to be spent within 31 months of the receipt by the business of the assets, and the working capital assets are actually used in a manner that is substantially consistent with the prior two requirements.

The Proposed Regulations make two changes to the safe harbor for working capital from the Initial Proposed Regulations. First, the written designation for planned use of working capital now includes the development of a trade or business in the QOZ as well as acquisition, construction and/or substantial improvement of tangible property. Second, exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action the application for which is completed during the 31-month period.

Meaning of Key Terms

The Proposed Regulations clarified several issues raised with respect to the QOZ program by providing guidance on the meaning of key terms used in the QOZ rules. For instance, the Proposed Regulations state that for purposes of the QOZ rules, a "trade or business" has the same meaning used for such term in section 162 of the Code. While the ownership and operation (including leasing) of real property is considered to be the active conduct of a trade or business for purposes of the QOZ rules, the Proposed Regulations are explicit 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 by such taxpayer.

Under the Initial Proposed Regulations, in order for stock and partnership interests held by a QOF to constitute qualified opportunity zone property, during "substantially all" of the QOF's holding period for the stock or partnership interests, such corporation or partnership must be a qualified opportunity zone business. Similarly, property is not treated as QOZ Business Property under the Initial Proposed Regulations unless during "substantially all" of the holding period of the QOF (or qualified opportunity zone business, as applicable) for such property, substantially all of the use of such property is in a QOZ. The Proposed Regulations provide that "substantially all" means (1) for purposes of the foregoing holding period requirements, at least 90 percent and (2) for purposes of the "use" requirement in the QOZ Business Property test, at least 70 percent.

Under the Initial Proposed Regulations, in order for a business to constitute a qualified opportunity zone business, a "substantial portion" of the intangible property of such business must be used in the active conduct of a trade or business in the QOZ. For these purposes, the Proposed Regulations define "substantial portion" to mean at least 40 percent.

Reinvestment Period for QOFs

The Proposed Regulations provide that if a QOF receives proceeds from the return of capital or the sale or disposition of some or all of its qualified opportunity zone property, and if the QOF reinvests some or all of the proceeds in qualified opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale or disposition, then the proceeds, to the extent that they are so reinvested, are treated as qualified opportunity zone property for purposes of the 90 percent asset test, but only to the extent that prior to the reinvestment in qualified opportunity zone property the proceeds are continuously held in cash, cash equivalents or debt instruments with a term of 18 months or less. If reinvestment of the proceeds is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of the 12-month requirement.

The foregoing rule is intended to allow QOFs a reasonable time to reinvest such proceeds without incurring penalties for failure to satisfy the 90 percent asset test. The Proposed Regulations did not, however, adopt a rule proposed by commenters to exempt QOFs and investors in QOFs from the federal income tax consequences of dispositions of qualified opportunity zone property by QOFs or qualified opportunity zone businesses if the proceeds from such dispositions are reinvested within a reasonable timeframe.

Investments Prior to Testing Dates

Under the Initial Proposed Regulations, a new QOF could delay the start of its status as a QOF (and thus the start of its 90 percent asset tests), theoretically providing the QOF the ability to prepare to deploy new capital before that capital is received and must be tested. Commentators noted this start-up rule does not help an existing QOF that receives new capital from an equity investor shortly before the next semi-annual testing date. The Proposed Regulations address this issue by allowing a QOF to apply the 90 percent asset test without taking into account any investments received in the preceding six months, provided that such investments are held continuously in cash, cash equivalents, or debt instruments with term of 18 months or less. For each semi-annual testing date, a QOF is permitted to make an independent determination whether to take investments received in the preceding six months into account for purposes of the 90 percent asset test.

Leased Tangible Property as Qualified Opportunity Zone Business Property

Based on the Code's definition of "qualified opportunity zone business property" ("QOZ Business Property"), commenters expressed concern whether tangible property leased by a QOF (or a qualified opportunity zone business, as applicable) can be treated as QOZ Business Property. The Proposed Regulations address this concern by allowing leased tangible property to be treated as QOZ Business Property if:

1. the property is acquired through a lease that is entered into after December 31, 2017;
2. the terms of the lease reflect common, arm's length market practice in the locale that includes the QOZ at the time that the lease was entered into;
3. during substantially all of the holding period of the QOF (or qualified opportunity zone business, as applicable) for the tangible property, substantially all of the use of the tangible property was in a QOZ; and
4. if the lessor and lessee are related, then
    a. the lessee 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 (i.e., no more than 12 months of rent can be prepaid); and
    b. if the "original use" of leased tangible personal property in a QOZ does not commence with the lessee, then during the 30-month period that begins on the date that the lessee receives possession of the property under the lease (or, if shorter, the period ending on the last day of the lease), the lessee must become the owner of tangible property that is QOZ Business Property having a value not less than the

value of that leased tangible personal property (with values being determined in accordance with the valuation methodologies described below, and such value in the case of leased tangible personal property being determined on the date the lessee receives possession of the property under the lease) and there must be substantial overlap of the zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property.

Under an anti-abuse rule in the Proposed Regulations, leased real property (other than unimproved land) is not QOZ Business Property at any time, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments.

Valuation of Leased Property

The Proposed Regulations provide two methodologies (the "applicable financial statement valuation method" and the "alternative valuation method") for valuing leased tangible property for purposes of satisfying the 90 percent asset test and for purposes of determining whether leased tangible property is QOZ Business Property. Once one of those valuation methods is selected for the taxable year, it must be applied consistently to all property valued with respect to the taxable year.

Under the applicable financial statement valuation method, the value of leased tangible property is the value of that property as reported on the applicable financial statement for the relevant reporting period. The applicable financial statement valuation method may be used only if the QOF has an applicable financial statement that is prepared according to US generally accepted accounting principles and requires an assignment of value to the lease of the tangible property.

Under the alternative valuation method, the value of tangible property that is leased by a QOF (or qualified opportunity zone business, as applicable) is determined based on a calculation of the sum of the present values (using a discount rate equal to the applicable federal rate) of the payments to be made under the lease, including all periods during which the lessee may extend the lease at a pre-defined rent. The value of leased tangible property under this alternative valuation method is calculated at the time the lease for such property is entered into, and then such calculated value is used as the value for such asset for all testing dates for purposes of determining whether the 90 percent asset test is satisfied and/or the leased tangible property is QOZ Business Property.

"Original Use"—Vacant Properties and Lessee Improvements

Under the statute and the Initial Proposed Regulations, in order to qualify as QOZ Business Property, among other things, the original use of such property in the QOZ must commence with the QOF (or qualified opportunity zone business, as applicable) or the QOF must substantially improve the property. The Proposed Regulations clarify that "original use" of tangible property in a QOZ commences on the date any person first places the property in service in the QOZ for purposes of depreciation or amortization (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner).

The Proposed Regulations provide a number of taxpayer-favorable rules relating to the "original use" requirement. If property has been unused or vacant for an uninterrupted period of at least five years, "original use" in the QOZ commences on the date after that period when any person first so uses or places the property in service in the QOZ. Furthermore, improvements made by a lessee to leased property satisfy the "original use" requirement as purchased property for the amount of the unadjusted cost basis under section 1012 of the Code for such improvements.

Unimproved Land as QOZ Business Property

The Proposed Regulations provide that unimproved land that is within a QOZ and acquired by purchase is not required to be substantially improved. At the same time, the Proposed Regulations also provide that a QOF may not rely on the foregoing proposed rule if the land is unimproved or minimally improved and the QOF or the QOZB purchases the land 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.

The preamble to the Proposed Regulations identifies certain concerns of the Treasury and the IRS relating to unimproved land. In this regard, the preamble notes that the holding of land for investment does not give rise to a trade or business and such land could not therefore be QOZ Business Property. The preamble further states that, in certain instances, the treatment of unimproved land as QOZ Business Property could lead to tax results that are inconsistent with the purposes of the QOZ rules. For example, a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop, whether active or fallow at that time, potentially (absent a separate prohibition) could be treated as QOZ Business Property without the QOF investing any new capital investment in, or increasing any economic activity or output of, that parcel. In such instances, the Treasury and the IRS have determined that the purposes of the QOZ rules would not be realized, and therefore the tax incentives otherwise provided under the QOZ rules should not be available. If a significant purpose for acquiring such unimproved land was to achieve that inappropriate tax result, the general anti-abuse rule (discussed below) would apply to treat the acquisition of the unimproved land as an acquisition of non-qualifying property for purposes of the QOZ rules. The Treasury and the IRS have requested comments on whether anti-abuse rules, in addition to the general anti-abuse rule, are needed to prevent such transactions or "land banking" by QOFs or qualified opportunity zone businesses, and on possible approaches to prevent such abuse.

Qualifying Investment in a QOF

If a taxpayer makes an investment in a QOF in part with gains for which a deferral election was made and in part with other funds, Code section 1400Z-2(e)(1) requires these two types of QOF investments to be treated as separate investments (a qualifying investment and a non-qualifying investment). Only the portion of the QOF investment that is made up of deferred gain is eligible for the tax benefits associated with the QOZ program.

The Proposed Regulations clarify that a taxpayer can acquire a qualifying investment in a QOF by 1) transferring cash or other property to a QOF in exchange for eligible interests in the QOF, regardless of whether the transfer is one in which the taxpayer would recognize gain or loss on the property transferred; or 2) acquiring an eligible interest in a QOF from a person other than the QOF. If a taxpayer receives an interest in a QOF for services rendered to the QOF, such interest is treated as a non-qualifying investment, thereby presumably making carried interests in a QOF ineligible for any tax exemption upon sale.

In cases where a taxpayer acquires an investment in a QOF by transferring property (other than cash) to the QOF in exchange for eligible interests in the QOF, the Proposed Regulations provide a set of rules for determining which portion of such interest in the QOF may be treated as a qualifying investment versus a non-qualifying investment. The amount of a taxpayer's qualifying investment cannot exceed the amount of gain to be deferred (and any investment in excess of such gain is treated as a non-qualifying investment).

Inclusion Events

Section 1400Z-2(b)(1) of the Code provides that the amount of gain that is deferred if a taxpayer makes a qualifying investment will be included in the taxpayer's income in the taxable year that includes the earlier of 1) the date on which the qualifying investment is sold or exchanged; or 2) December 31, 2026. By using the terms "sold or exchanged," section 1400Z-2(b)(1) does not directly address dispositions that are not technically a "sale or exchange" (e.g., gifts and bequests).

The Proposed Regulations contain detailed rules concerning the types of transfers of qualifying investments that will trigger the deferred gain (referred to as "inclusion events"). Among other types of transfers, inclusion events include transfers by gift (whether outright or in trust and regardless of whether the transfer is a completed gift for federal gift tax purposes), a distribution by a QOF partnership of property that has a value in excess of the distributee partner's basis in its qualifying investment in the QOF partnership, a distribution of property with respect to stock in a QOF corporation to the extent it is treated as gain from the sale or exchange of property under section 301(c)(3) of the Code, and certain transfers of interests in an S corporation or partnership that are themselves a direct investor in a QOF. Transfers by reason of death (to the decedent's estate, or from the estate to the decedent's heirs) are not inclusion events. Special rules apply for purposes of applying the rules relating to inclusion events to taxpayers who hold a "mixed-fund investment" (i.e., an interest in QOF that is treated as two separate investments, consisting of a qualifying investment and a non-qualifying investment).

Election for Qualifying Investment Held for 10 Years

Under section 1400Z-2(c) of the Code, a taxpayer that has held a qualifying investment in a QOF for at least 10 years may elect to have the basis of such property equal to the fair market value of such investment on the date the investment is sold or exchanged. The effect of this election is to permit the taxpayer to eliminate the tax on any appreciation in the value of its qualifying investment. However, since the Code refers to a sale or exchange of "the investment," it had been generally understood that a taxpayer could only make this election when it sells its interest in a QOF, and that the election is not available for gains passed through to a taxpayer when, for example, a QOF partnership sells its interest in underlying qualified opportunity zone property.

The Proposed Regulations expand the availability of the step-up election under section 1400Z-2(c) of the Code. If a taxpayer has held a qualifying investment in a QOF that is a partnership or S corporation for at least 10 years, and the QOF partnership or QOF S corporation disposes of qualified opportunity zone property after such 10 year holding period, the taxpayer may make an election to exclude from gross income some or all of the capital gain arising from such disposition reported to the taxpayer on Schedule K-1 and attributable to the qualifying investment. In a similar manner, a shareholder of a QOF that is a REIT and that receives a capital gain dividend identified with a date may treat the capital gain dividend, or part thereof, as gain from the sale or exchange of a qualifying investment on the date that the QOF REIT identified with the dividend. If, on the date identified, the shareholder had held that qualifying investment in the QOF REIT for at least 10 years, then the shareholder may apply a zero percent tax rate to that capital gain dividend, or part thereof.

Anti-Abuse Rules

The Proposed Regulations provide a general anti-abuse rule stating that the QOZ rules must be applied in a manner consistent with the purposes of section 1400Z-2 of the Code. Accordingly, if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of Code section 1400Z-2, the Commissioner can recast a transaction (or series of transactions) for federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of Code section 1400Z-2. Whether a tax result is inconsistent with the purposes of Code section 1400Z-2 must be determined based on all the facts and circumstances.

Future Guidance

The preamble to the Proposed Regulations indicates that in coming months, the Treasury and the IRS expect to address the penalties under Code section 1400Z-2(f) applicable to a QOF that fails to maintain the required 90 percent investment standard, as well as information-reporting requirements for an eligible taxpayer under Code section 1400Z-2, in separate regulations, forms or publications.

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