April 2019

OPPORTUNITY ZONES

Qualified Opportunity Zone Update

New Guidance from Treasury

On Wednesday, April 17, 2019, the U.S. Department of the Treasury released a second set of Proposed Regulations for the Qualified Opportunity Zone (QOZ) tax incentive program under Internal Revenue Code section 1400Z-2. These regulations were heavily influenced by input from hundreds of economic development and tax professionals over the last year, including a public hearing this February in Washington D.C. that was standing room only.

Many of the key issues left open by the original set of regulations issued in October 2018 have been addressed in these new rules, which should open the door to investors who have been hesitant to move forward with QOZ projects while lacking specific guidance. Taxpayers may rely upon Proposed Regulations until such time as regulations are made final, if they apply the rules consistently and in their entirety. Another hearing for public comment has been scheduled for July 9, and comments may also be submitted electronically to the Treasury Department. Additional guidance is planned before the end of 2019.

Highlights of key provisions in the new Proposed Regulations are outlined here. GBQ will issue additional detailed guidance in the coming weeks as we consider these rules and the practical impact that they will have on investors, developers and business owners.

Background

1. A **temporary deferral** of taxable income on recognized capital gains that are invested in a QOF until the interest in the Fund is sold or December 31, 2026, whichever is earlier,
2. A **step up in basis** related to the deferred gain if the QOF investment is held for more than 5 years, with an additional step up for a 7-year holding period, and
3. A **permanent exclusion** of capital gains tax on appreciation of the investment held within the QOF if it is held for 10 years or more.

For additional background and details about the structure of QOZ deals, see previous GBQ publications at **Qualified Opportunity Zone Update February 2019.**

Highlights of the New Regulations

Substantially All: Used throughout the original legislation, the phrase "substantially all" lacked specific definition in most contexts. The Proposed Regulations provide that a qualified opportunity zone business is a trade or business in which substantially all (at least 70%) of the tangible property owned or leased by the taxpayer is "qualified opportunity zone business property."

> Qualified opportunity zone business property is tangible property that meets the following requirements:
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> 1. The tangible property was acquired by purchase after 12/31/17,
> 2. The original use of such property in the qualified opportunity zone begins with the business, or the business substantially improves the property, and
> 3. For substantially all of the business' holding period of the property (now defined as 90%), the property is used in the qualified opportunity zone.

Original Use: The original use of tangible property acquired by purchase starts when the property is first placed in service in the opportunity zone for purposes of depreciation or amortization. Used property may qualify if it has not previously been placed into service in the opportunity zone. Additionally, a taxpayer's improvements to leased property by a lessee will satisfy the original use requirement.

Buildings located in an opportunity zone that have been vacant for five years prior to the purchase by a qualified opportunity fund or a qualified opportunity zone business will satisfy the "original use" requirements. The original use requirement is not applicable to land, but land must be used in a trade or business, not simply held for investment, in order to qualify.

Leases: Tangible property that is leased within an opportunity zone after 12/31/17 may qualify as qualified opportunity zone business property, provided that it is a "market rate lease" and meets the 70% use requirement. If the lessor and lessee are related parties, the opportunity zone business or the opportunity fund may not make prepayments to the lessor that exceed 12 months.

Active Conduct of Business: For each tax year, at least 50% of the gross income of a QOZ business must be derived from the active conduct of a trade or business in the QOZ. Further, a substantial portion of the intangible property of a QOZ business must be used in the active conduct of a trade or business in a QOZ.

> The Proposed Regulations provide three safe harbors for determining whether sufficient income is derived from a trade or business in an opportunity zone for purposes of the 50% test. Businesses only need to meet one of these safe harbor tests:
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> 1. 50% of the services performed by employees or independent contractors, as measured by hours worked, are in the zone,
> 2. 50% of the services performed by employees or independent contractors, as measured by compensation dollars, are in the zone, or
> 3. The tangible property of the business is in the zone, AND the management or operational functions performed for the business in the zone are necessary to generate 50% of the gross income of the business.

In addition, taxpayers who do not meet one of the above tests may meet the 50% active conduct of business requirements by using a facts and circumstances test to demonstrate that 50% of the gross income of the trade or business is in the zone.

The Proposed Regulations specifically provide that owning and operating real property as a landlord is treated as the active conduct of a trade or business.

QOF Reinvestment: There was significant public comment on the topic of exiting investments and re-deploying capital within a qualified opportunity fund. The Proposed Regulations provide that proceeds received by a QOF from the sale or disposition of qualified opportunity zone business property, stock or partnership interest are treated as qualified opportunity zone property for purposes of the 90% investment requirement, so long as the QOF reinvests the proceeds received by the QOF within 12 months of such distribution, sale, or disposition. The one-year rule is intended to allow QOFs adequate time in which to reinvest proceeds. Such sales within the QOF do not impact investors' holding periods or trigger inclusion of the deferred gain as long as an investor does not dispose of his/her interest in the QOF.

Other: The Proposed Regulations provide a long (but non-exclusionary) list of specific QOF transactions that will cause the inclusion of deferred gains in income. There are also provisions regarding the timing of basis adjustments and specific guidance regarding investors with mixed-fund investments of both qualified capital gain funds and non-qualified cash equity, as well as partnership carried interests. Future publications will explore these topics in greater depth.

GBQ has worked with investors, real estate developers and business owners to complete deals in opportunity zones.

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