



The Second Tranche of Opportunity Zone Regulations: Answers to "Substantially All" of Our Lingering Questions

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On April 17, 2019, the U.S. Department of Treasury and the Internal Revenue Service released their highly anticipated second tranche of qualified opportunity zone (QOZ) proposed regulations^[1]

This second set of proposed rules addresses many of the issues that remained after the first tranche of proposed regulations was issued last October and should provide sponsors and investors with the information necessary to finalize transaction structures and deploy funds for OZ projects^[2] This article summarizes significant aspects of the new OZ guidance from Treasury and the IRS.

A Summary of the Recent Guidance

The Proposed Regulations

QOF Testing

Option to Disregard Recently Contributed Property? To the extent that a qualified opportunity fund (a QOF) receives a contribution of money or other property in exchange for QOF partnership interests or stock of a QOF corporation, and such contribution occurs within 6 months of a QOF compliance testing date, the QOF may disregard the contribution and exclude it from the numerator and denominator of its applicable QOF test so long as the amount of the contribution is continuously held in cash or cash equivalents during the exclusion period.

Asset Valuation Methodology? For purposes of the 90% asset test, QOFs may elect to use the financial statement valuation method or the alternative valuation method, which is based on the unadjusted cost basis of a QOF's assets, on an annual basis. In either case, a QOF must consistently apply the valuation method selected with respect to the applicable taxable year.

Mixed-Use Funds

Qualifying and Non-Qualifying Partnership Investments ? A partner making both a qualifying and a non-qualifying investment in a QOF partnership is treated as holding two separate interests for OZ purposes. All 704(b) partnership items, such as income, gain, loss and deduction, and all 752 debt allocations, must be allocated on a proportionate basis between the two interests. The relative allocation percentages would be based on the capital contributions for qualifying investments and for non-qualifying investments.

These rules treat profits interests that are received for services rendered to a QOF partnership as a non-qualifying investment. In the case of such interests, special allocation rules apply, with the allocable percentage attributable to the profits interest being the partner's highest percentage interest in residual profits attributable to its interest.

?Substantially All?

The ?Use? and ?Holding Period? Requirements ? In determining whether a QOF or an opportunity zone business (an ?OZ Business?) uses ?substantially all? its opportunity zone business property (?OZBP?) within an OZ for ?substantially all? of its holding period for such OZBP, Treasury is imposing a 70% threshold to the meaning of ?substantially all? in the context of the ?use? requirement,? and, in the case of the ?holding period? requirement, it is imposing a 90% threshold to the meaning of ?substantially all.?

OZ Business Requirements

Gross Income ? At least 50% of the total gross income of an OZ Business must be derived from the active conduct of a trade or business within an OZ. The following safe harbors apply in determining whether an OZ Business's activities are derived within an OZ:

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The Hours-Based Safe Harbor ? The first safe harbor uses employee and independent contractor hours to determine where the services of an OZ Business are performed. An OZ Business will be deemed to have satisfied the ?gross income? requirement if at least 50% of the services performed by the OZ Business occur within the OZ, determined by a fraction, the numerator of which is the total hours worked by employees and independent contractors within an OZ for the taxable year, and the denominator of which is the total hours worked by employees and independent contractors for the taxable year.

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The Compensation Safe Harbor? The second safe harbor is based on amounts paid by an OZ Business for services rendered in an OZ. If at least 50% of the services performed by an OZ Business occur within the OZ, determined by a fraction, the numerator of which is the total amount paid for services performed in an OZ during the taxable year, and the denominator of which is the total amount paid for services during the taxable year, the OZ Business will be deemed to have satisfied the "gross income" requirement.

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The Property and Functionality Safe Harbor? Finally, if, based on facts and circumstances, the tangible property of the trade or business located within an OZ and the management or operational functions of the OZ Business that are performed within an OZ are essential to the generation of at least 50% of the OZ Business's gross income, the OZ Business will be deemed to have satisfied the "gross income" requirement.

Intangible Property? In determining whether a "substantial portion" of an OZ Business's intangible property is used in the active conduct of such OZ Business's trade or business, Treasury has established a 40% threshold.

Active Conduct of a Trade or Business? Whether an OZ Business (or a QOF, for that matter) is engaged in a "trade or business" is to be determined based on an analysis of the facts and circumstances of the situation considering Code Section 162. Treasury, however, has reserved a provision in the proposed regulations for the meaning of "active conduct of a trade or business," except in the case of property leases. In that instance, the proposed regulations provide that the ownership and operation (including leasing) of real property is the active conduct of a trade or business, but merely triple net leasing real property owned by an OZ Business is not the active conduct of a trade or business.

OZBP Requirements

Original Use? For property that is owned by a QOF or an OZ Business, the "original use" requirement is satisfied if the property has not previously been (i) placed in service in the OZ for purposes of depreciation or amortization or (ii) used in the OZ in a manner that would allow depreciation or amortization if such prior user were the owner of the OZBP. If the OZBP has sat unused or vacant for an uninterrupted period of at least 5 years prior to its placement in service by the a QOF or OZ Business, then any use of the property prior to that 5-year period of vacancy or non-use is ignored for purposes of the "original use" requirement.

Leased Property? There is no "original use" or "substantial improvement" requirement for property that is leased by a QOF or an OZ Business from an unrelated party. If, however, a QOF or an OZ Business leases OZBP from a related party, (i) the terms of the lease must be market rate, as between third parties, (ii) there can be no prepayments made under the lease relating to a period that exceeds 12 months, and (iii) the QOF or the OZ Business must (a) satisfy the "original use" requirement, or, (b) within 30 months of taking possession (or the end of the lease term, if sooner), acquire ownership of OZBP with a value equal to or greater than the leased property to be used in an overlapping OZ.

Unimproved Land? Unimproved land within an OZ does not need to meet the "substantial improvement" test under the OZBP requirements.

Sales of OZ Property

Reinvestments Prior to 12/31/26 and 10-Year Hold? A QOF may reinvest proceeds from the sale of OZ Property in other OZ Property within 12 months of the sale without violating the 90% asset requirement applicable to QOFs. All proceeds of the sale, however, must be continuously maintained in cash or cash equivalents. While proceeds, including gains, from the sale of OZ Property may be reinvested in other OZ Property without triggering an "inclusion event," QOF investors must recognize any gains in the year of sale.

Fair-Market-Value-Basis Election on Exit

Exit Election for Direct Investors in OZ fund Partnership and OZ fund S corporations? A taxpayer that is the holder of a direct qualifying QOF interest in a flow-through entity (a QOF partnership or QOF S corporation) may make an election to exclude from gross income some or all of the capital gain from the disposition of qualified opportunity zone property ("OZ Property") that is reported to the taxpayer on Schedule K-1, provided that the disposition occurs after the taxpayer's 10-year holding period for its QOF interest. Any such gain reported to the taxpayer on Schedule K-1 must be separately stated as arising from the sale or exchange of OZ Property.

Anti-Abuse Rule

Generally? The proposed regulations contain an anti-abuse provision that is directed to any transaction or series of transactions that are inconsistent with the OZ program. The Commissioner has broad discretion to implement this rule.

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While this alert is a recitation of the recent guidance from the Treasury and IRS, we plan to issue a subsequent alert analyzing the impact of this guidance on OZ investors, QOFs and OZ Businesses. In the meantime, if you have any OZ questions, please contact a member of our OZ team, or **visit our OZ resource page**.

[1] REG 120186-18.

[2] In an April 17th press briefing, senior Treasury officials stated that this second tranche of proposed rules is an attempt to answer all remaining questions about the OZ program and will, therefore, be the last set of new proposed rules, unless it appears that a third tranche is necessary.

Related People

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