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Opportunity zones: Highlights of the second set of proposed regulations

The U.S. Treasury Department and IRS yesterday issued a version of proposed regulations as guidance providing additional details about investment in qualified opportunity zones.

Read the **proposed regulations** [PDF 962 KB] (169 pages)

Read a **May 2019 report** [PDF 708 KB] providing a summary and observations about the proposed qualified opportunity zone regulations.

Background

The statutory opportunity zone regime—enacted as part of the December 2017 tax reform legislation (Pub. L. No. 115-97)—allows the deferral of all or part of a gain that would otherwise be includible in income if the gain is invested into a Qualified Opportunity Fund ("QOF"). The gain is deferred until the investment is sold or exchanged, or December 31, 2026, whichever is earlier. If the investment is held for at least 10 years, investors may be able to permanently exclude gain from the sale or exchange of an investment in a QOF.

While the opportunity zone statute and a prior round of proposed regulations provide an overall structure for the program and answer some basic questions, investors and those interested in developing zone-based businesses have been awaiting more detailed guidance. The proposed regulations released yesterday appear to answer many (though certainly not all) of the questions taxpayers have been asking, and provide some welcome flexibility to investors and businesses that want to take advantage of the opportunity zone incentives. Below are some highlights.

Highlights of proposed regulations

Qualified opportunity zone business ("QOZB") property ("QOZBP") is tangible property used in a trade or business of the QOF if the property was purchased after December 31, 2017. The proposed regulations permit tangible property acquired after December 31, 2017, under a market rate lease to

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qualify as "qualified opportunity zone business property" if during substantially all of the holding period of the property, substantially all of the use of the property was in a qualified opportunity zone.

A key part of the newly released proposed regulations clarifies the "substantially all" requirements for (i) the holding period and (ii) the use of the tangible business property as follows:

- For use of the property, at least 70% of the property must be used in a qualified opportunity zone ("QOZ").

- For the holding period of the property, tangible property must be QOZBP for at least 90% of the QOF's or QOZB's holding period.

- For the holding period of a Partnership or corporation owned by a QOF, such entity must be a QOZB for at least 90% of the QOF's holding period.

The guidance notes there are situations when deferred gains may become taxable if investors transfer their interest in a QOF. For example, if the transfer is done by gift, the deferred gain may become accelerated. However, inheritance by an heir is not a taxable transfer, nor is a transfer, upon death, of an ownership interest in a QOF to an estate or a revocable trust that becomes irrevocable upon death.

Summary of other highlights of proposed regulations

Section 1231 gains

The Treasury and the IRS have addressed the issues associated with treating section 1231 gains as capital gains. Specifically, the proposed regulations provide that the only gain arising from section 1231 property that is eligible for deferral is **capital gain net income** for a tax year. This net amount is determined by taking into account all the section 1231 gains and section 1231 losses for a tax year on all of the taxpayer's section 1231 property. While not specifically addressed in the proposed regulations, it would appear that the reference to taxpayer implies that a partnership, or its partner may be treated as a taxpayer.

The 180-day period to reinvest into a QOF with respect to the capital gain net income from section 1231 property for a tax year begins on the last day of the tax year.

Tax rate to apply to deferred gain

Some commentators have argued that the deferred gain should be taxed at the end of the deferral period at the same rate in effect in the tax year in which the gain was originally recognized, arguing that the reference to section 1(h) (which specifies a tax rate) in the definition of eligible gains provides support for this position.

The Treasury and the IRS have not provided such a rule. Instead, the proposed regulations require that the taxpayer simply include the gain in income in the year in which the deferral period ends, which would appear to require that the taxpayer pay tax based on the prevailing tax rates in that year.

Treatment of land and leases of land and other property

The proposed regulations addressed many of the issues raised by commentators, such as how to treat the acquisition of raw land by purchase, by lease, and by contribution. One of the main issues is how the acquired interest in land will be treated for purposes of applying the 90% and 70% asset tests and the "substantial improvement" requirement.

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The proposed regulations provide that unimproved land within a QOZ that is acquired by purchase is not required to be substantially improved.

- However, 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, then the land is not QOZB property.

- Substantial improvement of a building wholly located on land in a QOZ is measured in relation to the QOZB's additions to the basis of the building. As such, it does not appear that capital expenditures for erecting a related building qualify as improvements to the existing building.

The proposed regulations provide that leased property is QOZB property if:

- The lease is entered into after 2017.

- Terms of the lease are market rate at the time the lease was entered into.

- Related-party leases must also not contain a prepayment of more than 12 months, and if the original use of the leased tangible personal property does not commence with the lessee, the lessee must become the owner of tangible property that is QOZB property having a value not less than the value of that leased tangible personal property during the relevant testing period (generally the earlier of 30 months after the date the lessee receives possession of the leased property or the last day of the lease term).

- The original use of the leased property in a QOZ commences on the date any person first places the property in service in the QOZ for depreciation purposes (same rule as for first use and vacant purchased property).

- Substantially all the use of the tangible property was in the QOZ (70% test).

- For leased real property, there is not a plan, intent or expectation that the QOF would purchase the property for other than fair market value (FMV) determined at the time of purchase. Note that fixed-price purchase options at a value estimated to be the FMV at the time of purchase would not appear to qualify.

Definition of "original use"

For purchased tangible property, the original use commences on the date any person first places the property in service in the QOZ for depreciation or amortization purposes (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). Thus for acquisitions of partially completed buildings, the original use would commence when the purchaser completed the building and placed the building into service for depreciation purposes.

- For property that has been unused or vacant for an uninterrupted period of at least five years, original use commences on the date after that period when any person first so uses or places in service the property in a QOZ.

- For used property that has never been used or placed in service in a QOZ before its purchase, original use commences when it is so used or placed in service in the QOZ. Otherwise, the used property has to be substantially improved.

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- Improvements made by a lessee to leased property satisfy the original use test as purchased property for the amount of the unadjusted cost basis under section 1012 of such improvements.

Transfers of QOF interests in non-recognition transactions

The proposed regulations address the consequences of the QOF interest holder transferring its interest in a section 721(a) transaction, or receiving an interest pursuant to a partnership or corporate merger or other corporate nontaxable reorganization, but do not address distributing out the interest to one or more of its partners.

- A contribution by a QOF owner of its direct or indirect partnership interest in a qualifying investment to a partnership in a section 721(a) transaction is not an inclusion event, provided the interest transfer does not cause a partnership termination of a QOF partnership, or the direct or indirect owner of a QOF, under section 708(b)(1).

- As such, an aggregator entity could be employed by have the investors contribute to the QOFs and then contribute their interests in the QOFs to a new partnership (i.e., the aggregator entity).

- A merger or consolidation of a partnership holding a qualifying investment or in a tiered situation does not result in an inclusion event except for the portion of the transaction that is otherwise treated as a sale or exchange.

Treatment of carried/profits interests

QOZ benefits are available for those partners that contribute capital and get their return from that capital.

If a taxpayer receives an eligible interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is not an eligible investment and will be treated as a mixed fund investment. While the proposed regulations provided some guidance on bifurcating the allocation percentage for each separate investment, exactly how the IRS is going to measure how much is from each is not clear.

Outstanding debt and distribution issues

- **Step up to FMV on exit after 10 years**: The proposed regulations provide that the step up to FMV on exit is to the gross FMV of the interest. In addition, the bases of the QOF partnership assets are also adjusted, with such adjustments calculated in a manner similar to a section 743(b) basis adjustment (treated as if the transferor partner had purchased the interest for FMV).

- **Debt-financed distributions**: The proposed regulations generally allow a debt-financed distribution (subject to the disguised sale rules) provided that the amount distributed does not exceed the partner's basis in its partnership interest.

  - **Distributions of cash, other property:** For that matter, the proposed regulations allow for a distribution of cash or other property from a QOF to a partner without triggering an inclusion event, provided the amount of cash and the FMV of the property distributed does not exceed the partner's basis in its partnership interest.

  - **Distributions that reduce qualifying investments**: If a partner contributions cash or other property to a partnership and the partnership makes a distribution to the partner that would have been treated as a disguised sale if: (1) the cash contributed were treated as non-cash

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property; or (2) in the case of a debt-financed distribution, the partner's share of the debt were zero, then that amount reduces the amount of the qualified investment.

Qualified opportunity zone business ("QOZB") 50% of gross Income rule

The proposed regulations retain the requirement that the gross income be derived from the active conduct of the trade or business in the opportunity zone.

However, 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 for purposes of the 50% test. The safe harbors are:

- At least 50% of the services performed, based on hours, by its employees and independent contractors are performed within the QOZ.

- At least 50% of the amounts paid by the trade or business for services executed by employees and independent contractors are performed in the QOZ.

- The tangible property of the trade or business located in a QOZ and the management or operational functions performed for the business in the QOZ are each necessary to generate at least 50% of the gross income of the trade or business.

Qualifying real estate related businesses: The ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple net lease of property is not the active conduct of a trade or business for QOZB purposes.

Multi-asset partnership or S corporation QOFs

The proposed regulations provide that if a taxpayer has held a qualifying investment in a QOF partnership or S corporation for at least 10 years, and the QOF partnership disposes of QOZ property after such 10-year period, the taxpayer may make an election to exclude from gross income some or all of the **capital gain** arising from such disposition reported on Schedule K-1 and attributable to the qualifying investment.

- To the extent the Schedule K-1 separately states capital gains arising from the sale or exchange of any particular QOZ property, the taxpayer may make an election with respect to such separately stated item.

- Note that this rule only will eliminate capital gain generated from the sale of QOF's QOZ property, whereas all gain is eliminated if the QOF partner sells its interest in the QOF.

    - Note that the proposed regulations do not address divisions of QOFs to facilitate a sale of a single property through a sale of all newly divided QOF interests.

    - Note also that unrecaptured section 1250 gain is capital gain for this purpose.

Sales of QOZ property during 10-year holding period

The proposed regulations provide for a 12-month period for a QOF to reinvest the proceeds from a sale or disposition of QOZ property into other QOZ property without the proceeds becoming being treated as non-QOZ property, provided the proceeds are held as short-term investments (e.g., working capital). Delays in reinvesting due to waiting for governmental action is not taken into account.

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- However, the proposed regulations do not defer the recognition of income or loss by the QOF on the disposition of the QOZ property.

- It may be possible for the investor in the QOF to defer the recognition of the controlled group allocation from the QOF by investing in another QOF.

Tiered partnerships

On the eligible gain point, the proposed regulations do not specifically address whether eligible gains can flow through tiers to the ultimate taxpayer or be used anywhere along the line by an upper-tier partnership. It may be that the IRS thought it was clear enough from the first set of proposed regulations.

See the discussion above for tiering up investments in QOFs through section 721 (non-recognition) transactions.

Inclusion events

The proposed regulations provide a nonexclusive list of 11 inclusion events for a taxpayer's qualifying investment to be included in the taxpayer's income. Examples include:

- Transfers of eligible interests by gift are inclusion events.

- Transfers of eligible interest by reason of the taxpayer's death are not inclusion events, and the holding period is tacked. Dispositions by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death are inclusion events.

- Distributions by a QOF C corporation are inclusion events, but only to the extent such distribution is treated as gain from a sale or exchange under section 301(c)(3).

- Redemptions by a QOF C corporation are inclusion events unless the stock of the QOF C corporation is held by a single shareholder or by members of a single consolidated group and the redemption would be treated as a dividend under section 302(d).

- Transfers of stock in a QOF C corporation or an interest in a QOF partnership in a section 351 exchange are generally inclusion events.

- A transfer of a QOF C corporation's assets in a reorganization qualifying under section 368(a)(1)(A), (C), (D), or (D) generally is not an inclusion event if the acquiring corporation is a QOF within a prescribed period of time after the transaction and no boot is received in the reorganization.

Other key provisions

- A taxpayer can acquire an eligible interest in a QOF by purchasing an eligible interest from an existing partner of the QOF. The amount of the investment is equal to the amount of cash or the FMV of the other property exchanged for the eligible interest.

- **First six-month testing date:** A QOF may choose to determine compliance with the 90% test by excluding from the numerator and denominator, if following requirements are met:

  - The amounts received by the QOF are solely in exchange for an interest in the QOF.

  - The exchange occurred not more than six months before the test from which it is being excluded.

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- Between the date of that exchange and the date of the test, the amount was held in short term investments.

- Valuation is done either by applicable financial statement value (only if leases are assigned a value) or by an alternative valuation method.

  - Alternative valuation method treats assets owned by the QOF as having a value equal to its unadjusted cost basis under section 1012, and assets leased by the QOF as have a value equal to the present value of the payments under the lease discounted by the AFR (similar to debt instruments), determined at the inception of the lease.

- A QOZB may benefit from multiple overlapping or sequential applications of the working capital safe harbor, provided that each application independently satisfies the requirements.

- Section 1397C(f), relating to property straddling QOZs, applies in making determinations under section 1397C(b)(2), (4), and (8).

- A QOF C corporation can be the common parent of a consolidated group but cannot be a subsidiary member of a consolidated group.

  - For purposes of qualifying for deferral, members of consolidated group are not treated as a single entity. Instead, the member that recognizes the eligible gain must be the member that makes the investment in the QOF. If a member of a consolidated group owns an interest in a QOF and a basis adjustment is made with respect to the QOF interest, the member of the group will be treated as receiving tax-exempt income for purposes of the investment adjustment rules in Reg. section 1.1502-32. As a result, any upper-tier member of the group that owns the member owning the QOF interest will increase its basis in the owning member by the amount of the basis adjustment. However, such adjustments do not tier-up and, thus, do not result in upward basis adjustments with respect to the stock of upper-tier members unless the basis of the qualifying investment is increased to its fair market value.

  - In applying the anti-loss duplication rules in Reg. section 1.1502-36(d), in determining whether to reduce the attributes of a subsidiary, a qualifying investment is taken into account in determining whether there is a duplicated loss. However, basis in such investment is not subject to attribute reduction, and instead to the extent a qualifying investment would be subject to attribute reduction, the basis in the subsidiary stock is instead reduced.

KPMG tax professionals are still reviewing and analyzing the proposed regulations and intend on issuing a more detailed special report about these regulations in the coming days.

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