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NEWS ANALYSIS

Patching Up the Cracks in the Road to OZ

by Marie Sapirie

The impending release of final regulations for the Opportunity Zone regime means that whatever Congress manages to scrape together — if anything — to help achieve the regime's supposed goal of reinvigorating struggling communities by providing incentives for capital infusion, Treasury will beat lawmakers to the punch in helping to sort out the details.

Legislative Mortar

The congressional proposals probably stand only little chance of passage anytime soon. Here's your cheat sheet to what's been proposed recently.

Rep. Henry C. "Hank" Johnson Jr., D-Ga., and Rep. Bobby L. Rush, D-Ill., would like to require qualified opportunity funds to meet new requirements regarding members of their investment advisory boards, investment diversity, and affordable housing investment (H.R. 4999). Their bill would require every investment to be reported to the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation, and the report would have to detail how the investment would affect different racial and ethnic groups within the zone. The investment advisory board requirement is intended to involve local government in directing investments to the zone's benefit.

Finance Committee Chair Chuck Grassley, R-Iowa, and committee member Tim Scott, R-S.C., introduced the IMPACT Act, which would require a QOF to report the value of total assets it holds and metrics on each investment in qualified Opportunity Zone stock or a qualified Opportunity Zone partnership interest, including the type of trades or businesses conducted by the corporation or partnership, its census tracts, the amount of investment in its stock or partnership interests, the value of property owned and leased, the number of residential units for real property, and the approximate average monthly number of full-time employees.

The bill would require reporting for each item of qualified Opportunity Zone business (QOZB) property the fund holds and on dispositions of investments by QOF investors. The reporting requirements are backstopped by penalties for funds of $500 per day, up to a possible $50,000, and penalties for investors of $5,000.

What to Look For in the Final Regs

Treasury had its work cut out for it in drafting the final regulations because many outstanding issues must be dealt with. Treasury officials have been optimistically saying that the final rules are expected by year-end. The rules arrived at the Office of Management and Budget's Office of Information and Regulatory Affairs on December 6, which puts a lot of pressure on OIRA to be speedy in its review.

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Treasury officials hope the review will be quick, and investors would also like guidance by year-end, but scrambling at the end of the year is inevitable regardless of when the package is released, thanks to the need for investors to deal with section 1231 gains on December 31. (Prior coverage: *Tax Notes Federal*, Dec. 9, 2019, p. 1673.) The first set of proposed regulations came out in October 2018 (REG-115420-18), and the second set was released in April (REG-120186-18). Those two sets have been consolidated into one package of final rules.

The main issue for investors and would-be investors in QOFs is how they'll exit their investments and reap the benefit of excluding post-acquisition gain on investments held for at least 10 years. Taxpayers that hold their QOF investments for at least five years get a basis increase of 10 percent of the original deferred gain, and 15 percent if they hold the investment for seven years.

The public hearing in February included requests that Treasury approve asset sales as a way to exit, but section 1400Z-2(c) seems to require the taxpayer to sell its interest in the QOF. The current solution is typically to set up single-

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asset funds, but that's inelegant. "They need to change the regulatory regime so that there is tax impact parity between an exit through a QOF interest sale or a QOF asset sale," said Daniel F. Cullen of Baker McKenzie. (Prior coverage: *Tax Notes*, Feb. 18, 2019, p. 815.)

Treasury's explanation in prop. reg. section 1.1400Z2(c)-1 that taxpayers that hold a qualifying investment for 10 years can make an election upon its sale or exchange to get a step-up in basis to fair market value, but also that they can't rely on that rule, "as these rules do not apply until January 1, 2028," was cold comfort. No one's taxes will be affected by the rules until then, but investors want to know what the consequences of their exit planning will be when they're entering the investment, as the American Institute of CPAs, among others, has pointed out. Treasury can't delay reliance on final regulations, so even if the final rules merely parrot the proposed rules, taxpayers will have more clarity on how to proceed.

Finalizing the rule that investors can exclude any allocation of capital gain on a Schedule K-1 if the QOF sells qualified Opportunity Zone property after 10 years wouldn't be particularly helpful to two-tier structures in which the QOF owns the QOZB, said Jessica Millett of Duval & Stachenfeld LLP. But allowing the exclusion for investors if the QOZB sells the property would simplify structuring by making commingled funds less cumbersome, she said. It could also help encourage investments. "The reason that there hasn't been quite as much uptake is that the current construct is very clunky and works best with a single asset," she said, in contrast to a private equity fund that can, and usually does, hold multiple assets in a single fund.

> ***More specific guidance about how to meet the requirements of the 31-month rule in the proposed regs' working capital safe harbor is important, Talansky said.***

For real estate projects in particular, investors want assurances that they won't run into problems with the trade or business requirement while the project is in the pre-development or beginning-of-construction phase, Millett said. Hotels that are operational, for example, would meet the requirement because they're clearly in the trade or business of providing shelter for travelers, but a hotel that's still being built is on less solid ground.

More specific guidance about how to meet the requirements of the 31-month rule in the proposed regs' working capital safe harbor is important, said Jonathan Talansky of King & Spalding LLP. Under the safe harbor, a written plan must be in place for how the money will be spent, but 31 months can be a difficult timeline for some projects. The IRS knows that under the new markets tax credit, businesses can be considered a trade or business as long as there's a reasonable expectation that they'll meet the definition of a trade or business within three years.

The 70 percent test for good property in the QOZB can be a challenge when deals involve some amount of property that doesn't meet the purchase requirement, because it's unclear when the test must be met, Millett said. For example, if an investor contributes land into a joint venture, the QOZB wouldn't pass the test at that point, but it might hit the 70 percent requirement when the building phase is complete. It would be helpful for planning purposes to know how much time projects have to get into compliance, she said.

> ***The treatment of section 1231 gains is a likely item for the final rules, but the lack of administrative leniency so far has resulted in contingency planning for the last day of 2019.***

Some investors who owned property before the Opportunity Zone regime and who want to develop it are entering ground lease transactions to manage the rule that property must be acquired by purchase post-2017 from an unrelated party, Talansky said. It would be helpful if the final rules could provide clarity about what taxpayers can do in leasing land, he said.

More guidance on triple net leases is expected in the final rules. The proposed rules said that "merely" entering a triple net lease for real property owned by a taxpayer didn't qualify as the active conduct of a trade or business, and the IRS and Treasury have been working on rules that will help taxpayers know what level of activity in

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a triple net situation is enough to meet that requirement. (Prior coverage: *Tax Notes Federal*, Oct. 14, 2019, p. 347.) Talansky said it would be helpful if the rules also addressed the application to a QOZB that conducts vertical development of a project and holds it for lease, as well as where the lines are for multiple triple net leases. Cullen added that the approach in the regulations under section 199A regarding the level of activity is appropriate because those rules acknowledge that managing a portfolio of triple net leases is an active business.

It's possible that the final regs will tackle the question whether a QOF corporation can be a subsidiary member of a consolidated group. (Prior analysis: *Tax Notes Federal*, July 29, 2019, p. 651.) Commentators have suggested that it's possible to combine the two regimes without too many contortions of the existing framework or inappropriate results. Whether Treasury will take a single-entity or separate-entity approach is a major question.

The proposed rules provide that the 180-day period for investing section 1231 gain starts on the last day of the tax year, which isn't ideal for taxpayers whose section 1231 gains are established much earlier in the year. Investors would prefer a rule that allows section 1231 gains that meet the netting requirement on the last day to be used earlier in the year. The treatment of section 1231 gains is a likely item for the final rules, but the lack of administrative leniency so far has resulted in contingency planning for the last day of 2019.

Because of the lack of clarity, investors have prepared in advance to determine and act on their net section 1231 gains by investing them on the same day, Cullen said. Taxpayers are setting up investments so that the plans are in place and ready to go on December 31 but are taking care not to give up constructive ownership yet, he said. "The amount of money that will be trying to move through the wires on the last day of this year was unnecessary from an administrative perspective," Cullen said.

Treasury has wrestled with how much reporting it can require under section 1400Z-2, and it looks like Congress should change the statute to require more than what the IRS has added to Form 8996, "Qualified Opportunity Fund." For the longevity of the Opportunity Zone regime, metrics that can be used to justify the tax expenditure are probably essential. ■

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