A Clearer Path to Opportunity Zones

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The much anticipated, and much delayed, second set of Proposed Regulations (the Round 2 Proposed Regulations) on the Opportunity Zone program (the OZ Program) were released this week. Overall, Treasury interpreted the rules to make it easier to participate in the OZ Program, and there are many helpful clarifications that should encourage investors and developers alike. Critically, we now have a framework to permit operating businesses to work within the OZ Program as well. Of course, there are still some foggy patches to navigate, and a few new provisions to be mindful of, so tread carefully.

Weighing in at 169 pages, the Round 2 Proposed Regulations are dense and full of technical provisions that we are still unpacking. In the meantime, here are the big reveals. This article assumes some familiarity with the OZ Program. If you are new to the OZ program, or need a refresher on some of the basics, see Qualified Opportunity Zones: Proposed Regulations Explained and Existing Owners of Property in an Opportunity Zone – Right Place, Right Time?.

Take Your Time: Qualified Opportunity Funds Can Hold Cash for Longer Periods of Time

There are two very helpful provisions in the Round 2 Proposed Regulations that permit a qualified opportunity fund (QOF) to keep cash on hand without triggering a failure of the 90% asset test that the QOF generally must meet twice a year.

First, a QOF can ignore any contributions received within the past six months when applying the 90% asset test on any testing date. This change addresses the concern that a QOF could not accept a contribution from an investor immediately before a testing date unless that cash could be invested right away (since cash is not a qualifying asset for purposes of the 90% test).

For example, if a QOF had qualifying property worth $80, and an investor contributed $20 to the QOF on December 30, 2019, the QOF would only have 80% qualifying assets on December 31, 2019. With this new rule, the QOF can ignore the $20 cash contribution on its December 31, 2019, asset testing date. This change should help to alleviate some of the artificial timing constraints that QOFs and investors were structuring around.

Second, if a QOF sells an asset, the QOF has 12 months to reinvest the cash proceeds before the cash becomes a bad asset for purposes of the 90% asset test. Helpfully, any recycling of capital into new investments under this provision does not affect an investor's holding period in its QOF interest, and as long as the cash is reinvested within the 12-month period, the recycling does not trigger inclusion of any of the investor's originally deferred gain. However, any gain recognized on the sale of the underlying assets is allocated to investors per normal tax rules, and QOF investors will have to pay tax on that gain. It remains to be seen how QOFs will manage this potential phantom income risk for investors.

Real Estate Projects Made Easier: Original Use

One of the big questions for real estate projects was how they could satisfy the "original use" test. (Remember that tangible property owned by a QOF or a qualified opportunity zone business (QOZB) needs to meet either the original use test or the substantial improvement test to qualify.)

Everyone assumed that ground up development would qualify (and it does), but the definition of original use in the Round 2 Proposed Regulations is broad enough to pick up situations where the QOF or QOZB acquires property in an opportunity zone that has already been built by the seller but is first "placed in service" by the QOF or QOZB as the buyer. (The placed-in-service date is what typically starts the clock for depreciation purposes.)

The Round 2 Proposed Regulations also say that the original use requirement can be satisfied for a previously used building as long as the building was vacant or unused for at least five consecutive years before the QOF or QOZB places the property in service. This should facilitate the redevelopment of existing abandoned buildings in opportunity zones.

Use It or Lose It: The Treatment of Land

Empty land can also qualify as a good asset as long as the land is used in a trade or business of the QOF or QOZB. However, if the land is not being used as part of a trade or business, the QOF or QOZB must have an expectation, intention, or plan to improve the land by more than an insubstantial amount within 30 months of acquisition. For example, using the land around a building for a parking lot, park, or playground should be fine, but an empty lot overgrown with weeds will not qualify as a good asset (unless you have a plan to improve the land within 30 months).

If you are acquiring a large parcel to develop in phases, keep these requirements in mind. Treasury continues to be worried about land banking, so more guidance may develop here.

Stop the Clock: Extensions of the 31-Month Working Capital Safe Harbor

One of the requirements applicable to QOZBs is a 5% limit on cash and financial property (the 5% Financial Property Limit). The provisions in the Internal Revenue Code (the Code) included an exception to this limitation so that QOZBs could hold reasonable amounts of working capital.

The first round of proposed regulations, which were released in October 2018 (the Round 1 Proposed Regulations), contained a safe harbor saying that QOZBs that are developing, constructing, or improving real estate (Real Estate QOZBs) can treat cash as reasonable working capital if certain requirements are met, including having a written plan and schedule to spend the funds within 31 months, as well as actually spending the cash consistently with the plan. The Round 2 Proposed Regulations now add three helpful expansions to this safe harbor.

First, the safe harbor now extends to QOZBs that will be developing a trade or business (Operating Business QOZBs) as well. This was a logical extension of the rule, since new and expanding operating businesses often have significant startup expenses.

Second, if there is a delay in spending the cash because of approval processes or government inaction on an application, then the delay will not cause a QOZB to fail the safe harbor. We expect that applications for building permits, zoning changes, tax lot changes, and environmental certificates should be picked up by this rule. The implementation of these freeze mechanics is not entirely clear, so keep complete records on when various applications are submitted so you can evidence your wait time if needed.

Third, a QOZB can have multiple overlapping or sequential applications of the 31-month safe harbor as long as each one can satisfy the requirements. If you anticipate that cash will come in over time, try to lump staggered contributions together for discrete phases. For example, bring initial cash in for property acquisition and predevelopment for the first 31-month safe harbor. Then bring the next round of cash in for initial construction, and document that as a separate workstream eligible for a separate 31-month safe harbor. This may result in some additional recordkeeping, but given the critical nature of the safe harbor, the planning and the extra documentation are worth it.

Keeping Your Money at Work: Distributions of Refinancing Proceeds

The OZ Program is intended to put investors' cash to work in opportunity zones and to keep it there for at least 10 years. Consequently, the Round 2 Proposed Regulations contain a list of inclusion events that will trigger an investor's deferred gain if the investor's interest is cashed out or otherwise reduced. But the rules also allow QOF investors to receive leveraged distributions tax free under certain circumstances.

The general partnership tax rules overlap with the special QOF basis rules in this area, so the Round 2 Proposed Regulations clarify that a distribution by a QOF to a partner is a taxable inclusion event only if the distribution exceeds the partner's basis in its QOF interest. Remember that a QOF investor has zero basis in its QOF interest on day one, gets 10% of its basis after five years, an additional 5% (for a total of 15%) after seven years, and then gets full basis credit for the original amount of eligible gain contributed to the QOF after 2026. Also, an investor in a QOF partnership receives basis credit for its share of any underlying debt. Depending on how the debt gets allocated (there are some technical rules here), an investor should be able to receive a distribution of refinancing proceeds to the extent of the investor's share of the debt, plus any basis credit the investor gets pursuant to the five-year, seven-year, and 2026 basis adjustments.

For example, assume Bruce and Terri form a QOF partnership on January 1, 2019, and they each contribute $200 of eligible gain. In November 2022, the QOF borrows $300 from a bank on a nonrecourse basis, which is allocated for tax purposes $150 to Bruce and $150 to Terri. If the QOF makes a distribution to Terri of $50 in December 2022, that distribution is not a taxable inclusion event since Terri had a basis of $150 from the debt allocation. Terri's basis after the distribution is $100.

Now assume that the $300 loan was instead fully allocable to Bruce for tax purposes so he gets the full $300 basis credit for the debt in November 2022. In January 2024, Bruce and Terri each get $20 of basis credit pursuant to the five-year rule. If the QOF makes a distribution to Terri of $50 in November 2024, Terri has to recognize $30 in income because she only had $20 of basis credit.

Consequences of the Zero Basis Rule: Suspended Depreciation

The zero-basis rule and the subsequent basis step-ups have raised numerous questions about depreciation. To the extent that a QOF investor cannot deduct its share of depreciation due to lack of basis, those amounts should be suspended losses, which would be freed up once the investor has sufficient basis to absorb them. The five-year, seven-year and 2026 basis adjustment should free up those suspended losses.

The Round 2 Proposed Regulations clarify that there should be no depreciation recapture at ultimate exit when a QOF investor makes a fair market value basis step-up election and sells its QOF interest. Note that any depreciation recapture resulting in ordinary income (such as depreciation on personal property) would have to be recognized if a QOF investor makes a 10 Year Asset Sale Election (described below), so any exit structuring should take this difference into account.

Predicting the Future: Exit Structuring

The 10-year tax benefit as drafted in the Code requires an investor to sell its QOF equity interest. This entity sale requirement has been causing significant friction both for structuring a multi-asset comingled fund as well as the required exit provisions in a single-asset QOF or QOZB. The Round 2 Proposed Regulations offer some potential relief here and include provisions that would permit a QOF investor to claim the benefit of the 10-year rule to exclude from income any capital gain resulting from certain property sales by a QOF partnership (the 10 Year Asset Sale Election).

There are a few things to keep in mind about this new 10 Year Asset Sale Election. First, the Round 2 Proposed Regulations only expressly permit the 10 Year Asset Sale Election for sales of property by a QOF. Since most QOF structures are being set up with a joint venture entity qualifying as a QOZB to hold the underlying property, to truly permit QOF investors to take advantage of the 10-year rule for property sales, the 10 Year Asset Sale Election should also apply to sales of property by a QOZB. There is language elsewhere in the Round 2 Proposed Regulations and in the preamble indicating that perhaps the provision was meant to apply to property sales by a QOZB as well as a QOF, but for the moment this is not as clear as we would like.

Second, the 10 Year Asset Sale Election only permits QOF investors to exclude capital gain from a sale of qualifying property from income, so any ordinary income that results from a qualifying sale is not excluded and would be taxable. Ordinary income would arise from the sale of dealer property such as inventory, and any depreciation recapture characterized as ordinary income would also have to be included in income.

Third, unlike the Round 1 Proposed Regulations and each other section of the Round 2 Proposed Regulations, taxpayers cannot rely on the 10 Year Asset Sale Election until the regulations are finalized. So, there is no protection for a structure that is put in place now which assumes that QOF investors will be able to claim the benefit of the 10-year rule for property sales. It remains to be seen how comfortable the market will be structuring true commingled funds and relying on property sales at exit.

In the meantime, although we expect that it would be incredibly difficult for Treasury to walk this rule back, we advise structuring a QOF in a manner that facilitates an entity sale at exit in case the 10 Year Asset Sale Election is not finalized (or not finalized in a helpful way).

Related Parties Welcome: The Treatment of Leases

Real estate investors hoping to use a lease in their QOF structure finally have some rules to work with. Leased property can qualify as qualified opportunity zone business property (QOZBP) if the lease was entered into after 2017, if the lease has arm's length and standard market terms, and if substantially all of the use of the leased property is in an opportunity zone for substantially all of the period for which the property is being leased by the QOF or QOZB.

Neither the original use requirement nor the substantial improvement requirement apply to leased property, which is particularly helpful for operating businesses as discussed below. Also, any improvements made to the leased property can satisfy the original use requirement, so, for example, a QOF or QOZB can be the tenant on a ground lease and build new property that should qualify as QOZBP.

Additionally, there is no requirement that the lessor and lessee be unrelated parties, as would be the case for property acquired by a QOF or QOZB by purchase. This is likely to be a huge help in structuring QOF transactions for existing owners of property in an opportunity zone. However, if the lessor and lessee are related, a few additional requirements kick in including a prohibition on prepayments. There is also an anti-abuse rule that disqualifies leased property as QOZBP if there is a plan, intent, or expectation that the underlying real property could be purchased for anything other than its fair market value at the time of purchase.

The Other Side of the Coin: Operating Businesses

Although the first wave of opportunity zone investments has largely been confined to the real estate industry, the Round 2 Proposed Regulations have kicked open the door to a potential tidal wave of investments into operating businesses in opportunity zones. Here is a quick guide on what those investments will look like and how they differ from real estate.

Keep in mind that the same two-tier structure applicable to real estate deals (QOF investing into a QOZB) will apply for operating businesses, and the same tax benefits apply to investors in a QOF that invest in an Operating Business QOZB. Also, the baseline requirements for an Operating Business QOZB are the same as those that apply to a real estate QOZB, but the asset mix will be different, and some of the rules apply differently.

Qualified Opportunity Zone Business Property

Substantially all (which is 70% for this purpose) of the tangible property owned or leased by the QOZB must be Qualified Opportunity Zone Business Property (QOZBP). Although this requirement is a heavy hitter for Real Estate QOZBs, expect this to play a much lesser role for an Operating Business QOZB. With the clarifications to leases in this round of guidance noted above, if Operating Business QOZBs enter into fair market value leases for their space and buy new business assets that are substantially used in an opportunity zone (office equipment, manufacturing supplies, etc.), this requirement should be satisfied.

50% Gross Income Requirement

At least 50% of the QOZB's gross income must be derived from the active conduct of its trade or business in an opportunity zone. The new guidance from the Round 2 Proposed Regulations for this requirement is getting a lot of attention, since, unlike real estate, which tends to (obviously) stay in place, an operating business has the ability to generate income from various locations. Treasury needed to strike a balance between keeping the focus on the geographical nature of the OZ Program and the reality that businesses often sell goods and services to customers nationally and even internationally.

Treasury provided three safe harbors that QOZBs can rely on to meet this requirement and an alternative facts and circumstances test:

1. The "Hours Safe Harbor" will be met if at least 50% of the services performed (based on hours) for the QOZB by its employees and independent contractors (and employees of independent contractors) are performed within an opportunity zone.

2. The "Compensation Safe Harbor" will be met if at least 50% of the services performed for the QOZB by its employees and independent contractors (and employees of independent contractors) are performed in an opportunity zone, based on amounts paid for the services performed.

3. The "Property and Management Safe Harbor" will be met if (1) the tangible property of the QOZB that is in an opportunity zone, and (2) the management or operational functions performed for the QOZB in an opportunity zone are each necessary to generate 50% of the gross income of the trade or business.

If none of these safe harbors are available, the QOZB can still satisfy this test if it can establish, based on all the facts and circumstances, that at least 50% of its gross income was derived from activities in an opportunity zone.

Intangible Property

A substantial portion of the QOZB's intangible property must be used in the active conduct of its trade or business in an opportunity zone. The Round 2 Proposed Regulations defined "substantial" for this purpose as 40%, so there is a fair amount of leeway here.

5% Financing Property Limit

The 5% Financial Property Limit applies to both Real Estate QOZBs and Operating Business QOZBs, but as noted above, the 31-month working capital safe harbor can be used by both.

No Sin Businesses

The QOZB cannot be a specified sin business, which includes massage parlors, gambling facilities, golf courses, and liquor stores.

Traps for the Unwary: Eligible Gain from Certain Real Estate Dispositions and No QOF Tax Benefits for Promotes

Two of the less welcome provisions of the Round 2 Proposed Regulations relate to the acquisition of a QOF interest with gain from the sale of real estate and the required contribution of Eligible Gain.

First, an investor that sells an appreciated real estate investment and wants to invest the resulting gain into a QOF should pay close attention to the applicable timing requirements. The normal rule is that an investor has 180 days from the date of sale to reinvest the Eligible Gain, and there are some variations on these timing rules for partners in a partnership.

However, real property that has been used in a trade or business (as opposed to having been held for investment) is technically characterized as Section 1231 gain. Even though Section 1231 gain is treated as capital gain and therefore is Eligible Gain for QOF purposes, a taxpayer cannot have Section 1231 gain until any gains subject to Section 1231 are netted with Section 1231 losses for that year. Only the net amount of Section 1231 gain constitutes Eligible Gain. Since a taxpayer does not know if it has Section 1231 gain until the end of the year, the Round 2 Proposed Regulations say that the 180-day period to invest Section 1231 gain as Eligible Gain does not begin until the last day of the taxable year.

This rule can have a fairly draconian effect given some of the timing requirements of the OZ Program, and also appears to be inconsistent with the intent and plain language of the Code, so we question whether it will stand. This is certain to be the subject of numerous comment letters to Treasury.

Second, the Round 2 Proposed Regulations clarify that QOF tax benefits will not apply to a QOF investor's entitlement to a promote or carried interest. For tax purposes, an investor's entitlement to a promote is considered to be a profits interests granted in exchange for services. Since QOF tax benefits are only available to investors who contribute Eligible Gain, investors who are granted a profits interest in exchange for services are not entitled to QOF tax benefits. Under the Round 2 Proposed Regulations, an investor that is granted a promote will be considered to have a mixed funds investment, with a portion of their investment eligible for QOF tax benefits and a separate portion that is not eligible.

And More . . .

Other topics covered in the Round 2 Proposed Regulations include:

- Definitions for the meaning of "substantially all" in various QOF and QOZB requirements
- Additional flexibility for investors to acquire an interest in a QOF either by contributing property or by purchasing an existing QOF interest
- Clarification that the substantial improvement test applies on an asset by asset basis
- Helpful provisions that permit QOFs to develop property that is partly within and partly outside of an opportunity zone
- Clarity that owning and operating real property (including leasing) qualifies as a trade or business but not a triple net lease
- Rules relating to the required inclusion of deferred gain in connection with certain transfers and reorganizations, but the transfer of a QOF interest upon death of the investor will not trigger inclusion, and the heirs step into the shoes of the original investor –and–
- Future reporting requirements

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Jessica Millett is co-chair of Duval & Stachenfeld's Tax Practice Group. She has particular expertise in U.S. tax issues that arise in complex real estate transactions, notably Qualified Opportunity Fund structures. She regularly advises clients on tax structuring and documentation for QOF investments, real estate acquisitions, joint ventures, restructurings and refinancing arrangements, including inbound and outbound investments, and structures involving REITs.

Most recently, Ms. Millett has been at the forefront of structuring investments into Opportunity Zones. To date, she has been quoted in Bloomberg, Real Estate Weekly, The Commercial Observer, and The Wall Street Journal and she has made numerous presentations to industry groups. Ms. Millett was also named as one of the Top 50 People Shaping the Future of Opportunity Zones by ***Opportunity Zone Magazine***.

Ms. Millett ensures that tax advice is an integral part of the deal from the very beginning. She is able to translate complex tax concepts into simple and straightforward issues, and clients appreciate that she is business savvy and understands the industry as well as the current market.