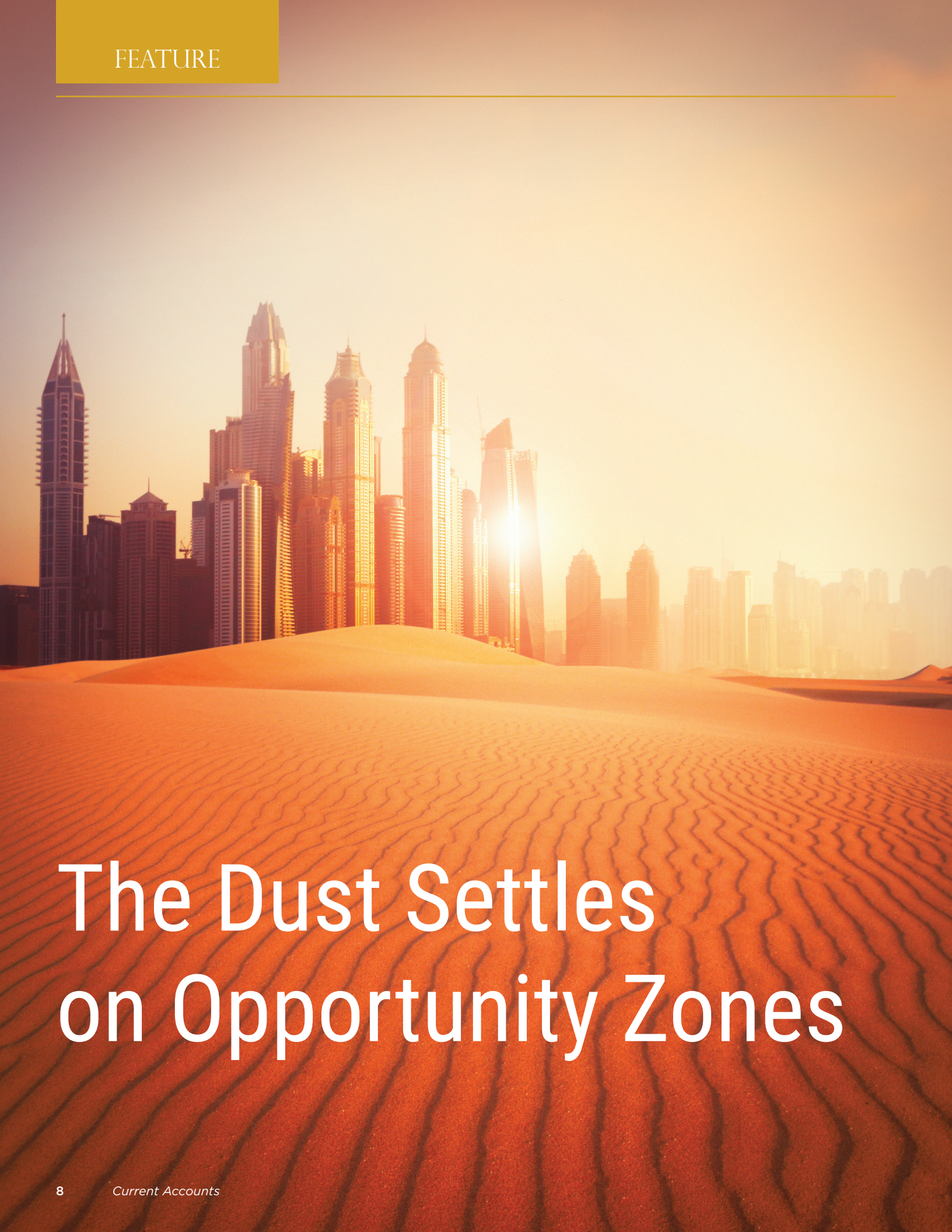

The Dust Settles on Opportunity Zones

Scrolling through the news, it probably does not take long before coming across the most compelling economic development incentive that America has seen in decades: the Qualified Opportunity Zone Incentive (QOZ Incentive). The QOZ Incentive promotes private investment in distressed communities by providing significant tax incentives to investors, including (1) deferred recognition of capital gains invested in a Qualified Opportunity Fund (QO Fund), (2) permanent exclusion of up to 15 percent of the original QO Fund investment and (3) permanent exclusion of capital gain taxes attributable to the QO Fund's appreciation.

It has now been over four months since the Internal Revenue Service (IRS) released the highly anticipated, and long overdue, second tranche of proposed regulations regarding the QOZ Incentive (2019 Proposed Regulations). The IRS published this second set of regulations to clarify and supplement the first set of proposed regulations, which had left investors, developers, business owners, attorneys, and accountants with more questions than answers. Although questions remain outstanding, it is evident that both sets of regulations deliver taxpayer-friendly rules primarily to promote the QOZ Incentive's success.

Notwithstanding the additional detail provided by the 2019 Proposed Regulations, taxpayers and their trusted advisors should keep in mind a critical concept that has not changed since the QOZ Incentive went into effect at the beginning of 2018. Regardless of the offered tax incentives, the fundamental soundness of the underlying investment and the track record of the QO fund sponsor in both tax-oriented private equity and real estate private equity are paramount in underwriting any investment. All too often taxpayers allow the proverbial "tax tail" to wag the dog or get fixated on pretty pictures in an offering memorandum, often resulting in foolish investments, which can erode the initial capital gains earned in the first place. Investors considering a QO Fund investment must weigh the prospects of long-term asset appreciation and current income benefit, and the attractive tax incentives offered by the QOZ Incentive against the potential risks of loss stemming from the investments they are contemplating.

While the risks and rewards associated with the investing decision matrix is a sexy topic, this article will instead focus on some of the significant legislative highlights from the 2019 Proposed Regulations. Importantly, the combined 169-pages of regulations and the Explanation of Provisions require careful reading and are time-consuming to digest. They contain information related to very technical and complex tax concepts, some of which we do not address due to the level of detail required to provide the reader with any sense of mastery of the issue. We also note that, for purposes of this article, we assume familiarity with the QOZ Incentive in general, as well as an understanding of the matters and issues, addressed or raised in the first tranche of proposed regulations, which released in October of 2018.

Capital Transactions.

(1) Investors need not sell their interests in QO Funds to take advantage of the 10-year gain exclusion. Instead, QO Funds taxed as partnerships or S corporations for federal income tax purposes can dispose of its assets in one or more separate transactions after an investor's 10-year holding period. This new flexibility promotes multi-asset QO Funds and enables the QO Fund to wind-down its assets and liquidate within a timeframe typical for private equity funds. The 2019 Proposed Regulations, as read, however, apply only to sales by QO Funds and not to sales by Qualified Opportunity Zone Businesses (QOZ Businesses).

(2) QO Funds generally have 12-months to reinvest proceeds from the sale or disposition of investments without violating the requirement that a QO Fund maintains at least 90 percent of its assets (90 percent Asset Test) in qualified opportunity zone property (QOZ Property). To treat such proceeds as QOZ

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Property before their reinvestment, they must be held continuously in cash, cash equivalents or debt instruments with a term of 18 months or less. Nonetheless, QO Fund investors will still be allocated their proportionate share of profit and loss from any sale of QOZ Property and will be subject to the tax consequences resulting from there, including the potential receipt of phantom income.

Underlying Assets – Qualified Opportunity Zone Business Property

The 2019 Proposed Regulations clarify how to determine whether real, personal and intangible assets are qualified opportunity zone business property (QOZ Business Property), for example:

- by defining "substantially all" in each place, it appears in Section 1400Z-2;
- by clarifying what property is subject to the "original use" requirement and how that requirement can be met (the "original use" of tangible property generally begins on the first date when such property could be depreciated or amortized in the same Qualified Opportunity Zone (QO Zone));
- by clarifying that the determination of whether the "substantial improvement test" is satisfied for the tangible property made on an asset-by-asset basis, as opposed to applying an aggregate standard that would allow the tangible property to be grouped;
- by clarifying how leased property can be QOZ Business Property (including property leased from related persons, thus effectively sanctioning ground leases from related parties); and
- by allowing the disregard of prior use of a building if the building has been vacant for at least five years.

What (Likely) Holds those Underlying Assets – The QOZ Business

1. The 2019 Proposed Regulations provide three independent safe harbors and a facts and circumstances test for determining whether an entity meets the requirement that they derive at least 50 percent of the entity's gross income from the active conduct of a trade or business in the QO Zone. The safe harbors alleviate concerns regarding how a business located within a QO Zone can satisfy this 50 percent gross income requirement if it sells its product outside of the QO Zone.
2. The ownership and operation, including leasing, of real estate will constitute an active trade or business unless the property is triple-net leased. Although triple-net-lease is not defined for purposes of the QOZ Incentive, the IRS has defined the term in the context of the Qualified Business Income Deduction under Section 199A. It is defined as a lease that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities.
3. The 2019 Proposed Regulations broadened the scope of the 31-month safe harbor for working capital to include the development of a trade or business in a QO Zone, opening the door for venture capital investments. The 2019 Proposed Regulations also clarify that separate 31-month periods can be used when a QOZ Business receives separate tranches of working capital, allowing for the continual operation of a business. Unfortunately, the 2019 Proposed Regulations do not extend an analogous working capital safe harbor to QO Funds, despite numerous requests from taxpayers to do so.

The Asset Tests

1. To address the concern that a QO Fund may be forced to deploy capital in less than desirable assets merely to satisfy the 90 percent Asset Test, the 2019 Proposed Regulations state a QO Fund may ignore investments for up to six months, as long as they hold those investments as cash, cash equivalents or debt instruments with a term of 18 months or less.
2. The 2019 Proposed Regulations explain how to measure assets for purposes of the 90 percent Asset Test at the QO Fund level and the 70 percent "substantially all" test at the QOZ Business level.

Investor Issues

1. Much to the chagrin of many QO Fund sponsors, the 2019 Proposed Regulations provide that carried interests received in QO Funds are not eligible for the tax benefits of the QOZ Incentive.
2. Despite the previous implication to the contrary, an investor can make an eligible investment in a QO Fund by contributing property other than cash to a QO Fund. It is unclear whether a QO Fund could then contribute that property to a QOZ Business partnership in exchange for a partnership interest in light of the statutory requirement that a QO Fund acquires the QOZ Business partnership interest "solely in exchange for cash."
3. Net gain from Section 1231 property is eligible for deferral under the QOZ Incentive (even though technically, Section 1231 properties do not constitute capital assets). A taxpayer must wait until the end of the tax year to determine if he or she has net Section 1231 gains or losses. Accordingly, taxpayers must be careful not to prematurely invest what they believe to be capital gain proceeds into a QO Fund before such proceeds become eligible for reinvestment.
4. The 2019 Proposed Regulations include a list of situations that will result in "inclusion events" (i.e., cases where recognition of the taxpayer's deferred gain will need to be before December 31, 2026). Importantly, debt-financed distributions from QO Funds that are taxed as partnerships do not necessarily result in an inclusion event (i.e., debt can provide a basis to avoid distributions triggering an inclusion event).

Looking Forward

Overall, we applaud the IRS's efforts and comprehensiveness with the 2019 Proposed Regulations. As is almost always the case though, the 2019 Proposed Regulations raise new questions, while leaving others unanswered. Notably, there are conflicting indications as to whether and when additional guidance will be issued. The preamble to the 2019 Proposed Regulations states that within "a few months of the publication of these proposed regulations," more guidance (specifically addressing administrative rules applicable to a QO Fund that fails to comply with the 90 percent Asset Test) will be published. In early March of this year, a Treasury official said the third round of guidance was expected and would address anti-abuse and decertification. However, on the same day, the 2019 Proposed Regulations were published, an official stated they expected no further proposed regulations unless another set of proposed regulations becomes "necessary." In the interim, the authors encourage the reader to reach out to them with questions surrounding the topic of the 2019 Proposed Regulations and QO Fund investments in general.

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