



April 2019

Follow @Paul_Hastings



IRS Issues Further Guidance on Qualified Opportunity Zones

By [Michael D. Haun](#) & [Kami LaBerge](#)

On April 17, 2019, the Internal Revenue Service (“IRS”) released further proposed Treasury Regulations to provide guidance on the tax incentive for investments in qualified opportunity zones, or (“QOZs”) under Section 1400Z-2 of the U.S. Internal Revenue Code (the “Code”), which was enacted as part of the Tax Cuts and Jobs Act of 2017. This is the second set of proposed regulations issued with respect to investments in QOZs, with the first set issued on October 19, 2018 and a third set expected to be issued in the coming months. The recently released proposed regulations clarify certain statutory requirements for a taxpayer to qualify for the incentive, including the meaning of “substantially all” each time it appears in the statute, transactions that trigger the inclusion of deferred gain, issues relating to timing and amount of deferred gain, further guidance on operating businesses, the treatment of rollovers of dispositions of investments in QOZs, the tax treatment of distributions of the financing proceeds, activities qualifying as “original use,” the treatment of leased property, and several other important issues. Many of these changes are taxpayer-friendly, in particular with respect to the guidance provided on operating businesses, which should spur increased activity in QOZ investments.

To qualify for the incentive, the taxpayer must generally invest gains from a sale of capital assets in a qualified opportunity fund, or “QOF” within 180 days after the sale of the asset that generated the gains.

Below is a brief summary of the more important provisions contained in the proposed regulations.

Gains Eligible for Deferral

Special Rule for Section 1231 Gains. If gains under Code Section 1231 for any taxable year exceed the Section 1231 losses, that net gain will be treated as an eligible gain for purposes of the QOZ statute. The 180-day period for investing that gain in a QOF begins on the last day of the taxable year.

Transfer of Property to QOF. If the taxpayer transfers property other than cash to a QOF in a carryover basis transaction, the amount of the eligible investment will be the lesser of (a) the taxpayer’s adjusted basis in the equity received in the transaction, or (b) the fair market value of the equity received in the transaction.

Mixed-Funds Investments. When a partner (a) contributes property to a QOF with a value in excess of its basis or cash in excess of the partner’s eligible gain or (b) receives a partnership interest in exchange for services, a mixed-funds investment will result. In each case, the deferral election will not



apply to the portion of the investment equal to the excess of the fair market value over the adjusted basis, or the excess of the investment amount over the eligible gain, as applicable. The effect of this proposal limits the tax benefits of the opportunity zone when contributing appreciated property or receiving an interest for services (i.e., a "carried interest").

Transactions Triggering the Inclusion of Deferred Gain

Gains timely invested into a QOF will be deferred for tax purposes until the taxpayer sells his or her interest in the QOF or December 31, 2026, whichever occurs earlier.

Events Giving Rise to Inclusion

Although the statute does not address dispositions resulting from a non-sale or exchange, the proposed regulations now provide a nonexclusive list of events giving rise to an inclusion event:

- Taxable dispositions of all or part of an equity interest in a QOF;
- Taxable dispositions of interests in an S corporation that has directly invested in a QOF, if, immediately after the disposition, the percentage of S corporation shareholders at the time the deferral election was made has changed by more than 25%;
- Certain transfers by a partner of a partnership interest, when that partnership holds a qualifying investment;
- Transfers by gift;
- Distributions to a partner in a QOF of property holding a value exceeding the basis of the partner's qualifying interest in the QOF;
- Certain distributions of property with respect to qualifying QOF stock under Code Section 301;
- Certain distributions of property with respect to qualifying QOF stock under Code Section 1368;
- Redemptions of qualifying QOF stock that is treated as an exchange of property for the redeemed qualifying QOF stock under Code Section 302;
- Dispositions of qualifying QOF stock in transactions to which Code Section 304 applies;
- Liquidations of a QOF corporation in a transaction to which Code Section 331 applies; and
- Certain nonrecognition transfers.

Debt-Financed Distributions to QOF Partners. To the extent that a partner in a QOF partnership receives a distribution of financing proceeds from the QOF partnership, the partner only has an inclusion event if the amount of the financing proceeds exceeds the partner's tax basis in its QOF interest. The partner's tax basis includes its allocated share of tax basis from the financing.

Timing of Basis Adjustments

As a general rule, basis adjustments that reflect the recognition of deferred gain upon the earlier of December 31, 2026, or an inclusion event, must be made immediately after the amount of deferred



capital gain is taken into income. The proposed regulations enumerate certain circumstances in which the taxpayer will adjust its basis prior to determining the tax consequences of the inclusion event.

Amount Includable Upon Inclusion Events

General Rule. If a taxpayer that holds an interest in a QOF has an inclusion event, it must include in taxable income: (a) the lesser of (i) the fair market value of the investment disposed of, and (ii) the amount bearing the same ratio to the remaining deferred gain as the first amount bears to the total fair market value of the qualifying investment immediately before the inclusion event, less (b) the taxpayer's tax basis in its QOF interest.

Inclusion Events Involving Partnerships. The amount includible is the percentage of the qualifying QOF partnership interest disposed of, multiplied by the lesser of: (a) the remaining deferred gain less certain basis adjustments or (b) the gain that the partner would recognize if it sold the interest for fair market value.

Inclusion Events Involving QOF Shareholder that is an S Corporation. If, immediately after the disposition, the percentage of S corporation shareholders at the time the deferral election was made has changed by more than 25%, all of the S corporation's remaining deferred gain is includable.

Special Election for Direct Investors in QOF Partnerships and QOF S Corporations

If the taxpayer sells or exchanges its interest in a QOF after holding it for more than ten years, any appreciation in the interest in the QOF is never taxed. For purposes of this rule, a direct investor in a QOF Partnership or QOF S Corporation that has held its QOF investment for more than ten years may elect to exclude from gross income some or all of the capital gain from the disposition of QOZ property reported on the entity's Schedule K-1. The taxpayer must make this election in the taxable year in which the taxpayer would include the capital gain from the disposition in its gross income. As a consequence of this election, (a) the amount of that capital gain will be excluded from income, and (b) for purposes of determining the taxpayer's basis in its QOF interest, the excluded amount will be treated as an item of income. This ability should address many of the exit concerns that QOF sponsors had with holding multiple investments in a QOF.

The 90% Asset Test

A QOF must hold 90% of its assets in "QOZ property," which is defined to include "QOZ business property" or equity interests in an operating subsidiary (treated as either a corporation or partnership for tax purposes) that qualifies as a "QOZ business," or "QOZB."

Valuation of Assets for Purposes of the 90% Asset Test. The regulations provide two methods by which property may be valued for purposes of the 90% asset test: (1) the applicable financial statement valuation method, under which the value of an asset is as reported on the applicable financial statement for the relevant reporting period, and (2) an alternative valuation method under which the value is (a) for assets owned by the QOF, the QOF's unadjusted cost basis of the asset under Code Section 1012, and (b) for assets leased by a QOF, the present value of payments to be made under the lease.

Option to Disregard Recently Contributed Property. A QOF may exclude any property received solely as contribution/in exchange for stock, if that exchange occurred fewer than six months previously and the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.



Proceeds from the Sale or Disposition of QOZ Property. When a QOF receives proceeds from the sale or disposition of QOZ property, the proceeds from that transfer are included in the 90% asset test, provided that the QOF reinvests those proceeds in QOZ property within 12 months. The proceeds must be held in cash or short-term investments similar to the previous paragraph. It is important to note that this reinvestment ability only eliminates the financial penalty involved with failing the 90% asset test. Absent future guidance, for sales occurring prior to the QOF owners holding their interest for at least 10 years, any taxable income generated from these sales must be recognized by the QOF or its owners, in the case of a pass-through QOF.

Qualifying as QOZ Business Property

The statute defines “QOZ business property” as tangible property that meets the following requirements: (1) it was acquired by the trade or business by purchase after December 31, 2017; (2) either (a) the original use of the property in the QOZ commences with the QOF or QOZB or (b) the QOF or QOZB substantially improves the property; and (3) for substantially all of the QOF or QOZB’s holding period of the tangible property, substantially all of the use of such property is in the QOZ. The proposed regulations offer further guidance on these requirements.

Original Use in the QOZ Commencing with the QOF

When “Original Use” Begins. Original use commences when a person first places the property in service in the particular QOZ for purposes of depreciation or amortization

Used Property. Used property will qualify if it has not been previously used within that QOZ in a manner that would allow it to be depreciated or amortized

Vacant Structures. If a structure has been vacant for at least five years prior to purchase by a QOF or QOZB, it will satisfy the original use requirement.

Unimproved Land and Land Acquired with a Building. Land can be treated as QOZ business property only if it is used in a trade or business of a QOF or a QOZB. A taxpayer who acquires raw land by purchase in accordance with the QOZ rules is not required to substantially improve that land. Similarly, land acquired along with a building is not required to be substantially improved. Anti-abuse rules apply: If a significant purpose for acquiring unimproved land is to achieve an inappropriate tax result, the acquisition of the land will be treated as an acquisition of non-qualifying property. This rule is intended to disqualify “land banking” from the benefits of the program.

The QOF or QOZB Substantially Improving the Property

Determination on an Asset-by-Asset Basis. Whether tangible property is “substantially improved” is determined on an asset-by-asset basis.

Holding Period and Use in the QOZ

Meaning of “Substantially All.” The QOZ statute uses the term “substantially all” in several places. The prior proposed regulations previously concluded that the term “substantially all” of the tangible property owned or leased by the QOZB means 70%. The new proposed regulations clarify that for purposes of the holding period usage, “substantially all” means 90% of the holding period, and for the use of the property in the QOZ, “substantially all” means 70%.

Treatment of Inventory. Inventory (including raw materials) may be considered used in a QOZ even if it is in transit to or from the QOZ.



Special Rules for Leased Property

General Requirements. To qualify as QOZ business property, leased tangible property must be acquired under a lease entered into after December 31, 2017, and substantially all of the use of the leased tangible property must be in a QOZ during substantially all of the period for which the business leases the property. There is no original use or substantial improvement requirement.

Leases from Related Parties Permitted. A lease from a related party will qualify, provided that: (a) the lease was entered into at arm's length; (b) the lessee does not make any prepayment exceeding 12 months; and (c) on the earlier of the end date of the lease or 30 months after the lessee gains possession of the property, the lessee becomes owner of tangible personal property that is QOZ business property that has a value equal to or greater than the value of the leased property.

Anti-Abuse Rules Apply. Leased real property will not qualify as QOZ business property if at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property without regard to prior lease payments.

Valuation of Leased Property. For purposes of the 90% asset test, leased property may be valued using the applicable financial statement method or the alternative valuation method described above.

Qualifying as a QOZB

A "QOZB" means a trade or business (a) in which substantially all (70%) of the tangible property owned or leased by the taxpayer is QOZ business property; (b) that satisfies the requirements of paragraphs (2), (4), and (8) of Code Section 1397C(b), and (c) is not a certain type of prohibited business.

"Trade or Business"

Defining "Trade or Business." Generally, only an entity engaging in activities giving rise to a trade or business under Code Section 162 (for which there is a well-established body of guidance) will qualify as a "trade or business" for purposes of qualifying as a QOZB. However, the proposed regulations provide an exception under which an entity that owns and operates (or leases) real property used in a trade or business will qualify as a "trade or business" for purposes of Code Section 1400Z-2 only. The act of entering into a triple-net-lease with respect to real property owned by the taxpayer, by itself, does not constitute the "active conduct of a trade or business."

Section 1397C(b) Requirements

Gross Income Requirement. Under Code Section 1397C(b)(2), the QOZB must derive at least 50% of its total gross income from the active conduct of a qualified business in a QOZ. Under the proposed regulations, this requirement can be satisfied if (a) at least 50% of the labor input (measured in hours or compensation paid) is located within a QOZ, or (b) tangible property of the QOZB located in a QOZ and management or operational functions performed in the QOZ are necessary to generate at least 50% of the gross income of the QOZB. Apart from these safe harbors, the guidance also provides that a QOZB may meet this test after considering all of the "facts and circumstances" of the QOZB.

Intangible Property Requirement. Under Code Section 1397C(b)(4), a substantial portion of the intangible property of a QOZB must be used in the active conduct of a trade or business in the QOZ. The proposed regulations explain that a "substantial portion" means at least 40%.



Treatment of Real Property Straddling a QOZ. Code Section 1397C(f) applies for purposes of determining whether a QOZ is the location of services for the purposes of the 50% test. If the amount of real property based on square footage located within the QOZ is substantial as compared to the amount of real property based on square footage outside of the zone, and the real property outside of the zone is contiguous to part or all of the real property located in the QOZ, then all of the property is deemed to be located within a QOZ.

Working Capital Safe Harbor

For a QOZB to meet the requirements for the 31-month working capital safe harbor, it must designate in writing the planned use of working capital, including, when appropriate, the acquisition, construction, and/or substantial improvement of tangible property in a QOZ. The proposed regulations expanded the safe harbor to include the development of a trade or business in the QOZ. Serial and overlapping 31-month working capital safe harbor periods are now expressly permitted. Further, a QOZB will not violate the safe harbor if the QOZB has requested government action during the 31-month period but the government does not act within that period.

Special Rules for Members of a Consolidated Group

Under the proposed regulations, a QOF that is a corporation for tax purposes can be a common parent of a consolidated group, but it cannot be a subsidiary member. In addition, the QOZ rules apply separately to each member of a consolidated group.

Conclusion

This is not a comprehensive summary of all of the new rules the proposed regulations have introduced into the QOZ landscape. We will be issuing a more comprehensive analysis of the impact of these proposed regulations in the coming weeks.



If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings Los Angeles lawyers:

Michael D. Haun
1.213.683.6119
michaelhaun@paulhastings.com

Kami LaBerge
1.213.683.6159
kamilaberge@paulhastings.com

Paul Hastings LLP

Stay Current is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2019 Paul Hastings LLP.