Bloomberg Tax

Daily Tax Report®

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INSIGHT: Second Wave of Opportunity Zone Guidance Addresses Many Key Issues, Leaves Open Questions for Future Guidance (PART 1)

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The Treasury Department and the Internal Revenue Service recently issued a second set of proposed regulations concerning the taxation of qualified opportunity zone funds (OZ funds) and their investors.

In our client alerts "Opportunity Zone Funds Offer New Tax Incentive for Long-Term Investment in Low-Income Communities" and "New Guidance for Opportunity Zone Funds Clarifies Important Issues, Leaves Door Open to Additional Guidance," we outlined the basic rules of the opportunity zone (OZ) regime, described the first set of proposed OZ regulations and identified a number of issues that were left unresolved. Like the initial proposed regulations, the new proposed regulations provide thoughtful, pragmatic, policy-oriented guidance on key issues and can be expected to encourage the formation and capitalization of OZ funds by:

- allowing investors to enjoy the tax exemption for gain on OZ fund investments held for 10 years (the OZ tax exemption) in cases where the OZ fund sells assets;
- providing a grace period to allow an OZ fund to deploy cash in a commercial manner following a capital raise;
- clarifying that an investor's outside basis in an OZ fund partnership interest is increased by the investor's share of the OZ fund partnership's debt, which is critically important for OZ fund partnerships focused on real estate;
- clarifying that an OZ fund can own and develop operating companies, including technology companies and service businesses;
- clarifying that an OZ fund can retain its status as such, notwithstanding certain unforeseen delays in the development of its property or the start-up of its business;
- providing rules pursuant to which an OZ fund or a qualified opportunity zone business (QOZB) (*i.e.*, a corporation or partnership in which an OZ fund owns an interest) can lease its assets, including from related parties;
- clarifying the "substantial improvement" requirement;
- clarifying that certain real property leasing activities will satisfy the "active trade or business" requirement;
- providing safe harbors for the 50% income test applicable to QOZBs;
- clarifying that an OZ fund can reinvest asset sale proceeds in qualified opportunity zone property (QOZP);
- narrowing the types of events that will trigger an OZ investor's deferred gain; and
- clarifying that an investor can use OZ-eligible capital to acquire an OZ fund interest on the secondary market, which will increase the liquidity of OZ fund interests generally and provide OZ fund sponsors with the ability to warehouse OZ fund interests pending syndication to OZ fund investors.

Although the regulations will become effective once finalized, a taxpayer may generally rely on them before then as long as the taxpayer applies the rules consis-

tently and in their entirety. A taxpayer's ability to rely on the rules, however, does not extend to certain rules regarding the application of the OZ tax exemption to the disposition of an OZ fund interest. Although these rules will not become relevant until Jan. 1, 2028 (at the earliest), they may be germane to structuring decisions made when the OZ fund is formed and acquires a QOZB, and the inability of taxpayers to rely on them is of concern.

Below is a summary of key provisions of the new proposed regulations and a discussion of important issues that remain unaddressed.

OZ Tax Exemption Available for Certain OZ Fund Asset Sales

Perhaps the most powerful incentive provided by the OZ regime is the OZ tax exemption, which allows eligible investors to exclude gains realized on the sale of an OZ fund interest held for at least 10 years. The statute is unclear whether the exemption applies in circumstances other than the sale by an investor of its OZ fund interest. This caused concern particularly among investors in and sponsors of multi-asset OZ funds organized as partnerships or real estate investment trusts (REITs), where, but for the requirements of the OZ regime, liquidity events would generally take the form of asset sales by the OZ fund or its subsidiaries. The new proposed regulations helpfully allow investors that satisfy the 10-year holding period to enjoy the OZ tax exemption on certain gains passed through to them when the OZ fund sells its assets (Proposed Treasury Regulations Section 1.1400Z-2(c)-1(b)(2)(ii)).

It is important to note, however, that, depending on the structure of the OZ fund and the level at which gain is recognized, similarly situated investors may experience disparate tax results, although it is not clear that these differences were intended. For example, it is clear under the new proposed regulations that an eligible investor that sells an OZ fund interest will not be subject to depreciation recapture with respect to assets held directly or indirectly by the OZ fund and that the investor can avail itself of the OZ tax exemption even if the OZ fund holds assets that are not QOZP. This is true regardless of whether the OZ fund is a partnership, an S corporation, or a REIT. Conversely, it would appear that, in the case of an OZ fund organized as a partnership or an S corporation, eligible investors will enjoy the OZ fund tax exemption only with respect to capital gains recognized by the OZ fund on the sale of QOZP and not with respect to gains characterized as ordinary income (such as gains attributable to unrealized receivables and inventory items) or gains recognized by the OZ fund on the sale of non-QOZP assets (such as intangibles and securities other than equity interests in a QOZB). The exemption also does not seem to apply to gains recognized on the sale of assets by a QOZB, whether or not such assets constitute QOZP. Accordingly, although the new proposed regulations expand the options for an OZ fund to exit an investment, these differences in income tax consequences may limit the ability of investors to avail themselves of these options.

In the case of an OZ fund REIT, the OZ tax exemption seems to apply with respect to any capital gain dividends attributable to long-term capital gains, whether recognized at the OZ fund level or by a QOZB, although it is unclear whether the exemption is limited to capital gains recognized on the sale of QOZP (Prop. Treas. Reg. Section 1.1400Z-1(e)). In addition, because the new proposed regulations specifically extend the OZ tax exemption only to REIT capital gain dividends, it seems dividends attributable to depreciation recapture would not be eligible for the exemption. As a consequence, some REIT OZ funds may find it prudent to structure a liquidity event as a sale of REIT assets followed by a series of liquidating distributions, rather than as a series of non-liquidating capital gain dividends. This is because the former structure entitles the OZ fund investor to the OZ tax exemption on all distributions made by the REIT in liquidation, including distributions in respect of non-QOZP assets and attributable to depreciation recapture.

90% Asset Test Excludes Newly Raised Capital for Six Months, Potentially Extending Capital Deployment Period to as Long as 43 Months

Under the statute, no more than 10% of an OZ fund's assets may consist of non-QOZP, including cash held as working capital, and a QOZB can hold only limited amounts of cash in excess of its reasonable working capital needs. These restrictions, together with the requirement that investors acquire their OZ fund interests within 180 days of a capital gain realization event, hindered the capital raising efforts of many OZ funds because a large enough inflow of capital shortly before an asset testing date could cause an OZ fund to fail the 90% asset test if the cash could not immediately be put to use. This issue was particularly pronounced for OZ funds that rely on a continuous equity offering mechanism given the increased likelihood that such funds might receive significant equity capital shortly before the June 30 testing date, which is the last opportunity for investors to roll over capital gains realized in the prior calendar year.

The new proposed regulations provide relief by permitting an OZ fund to exclude contributed capital from the 90% asset test for six months after it is received from investors, as long as it is held in cash, cash equivalents, or short-term debt instruments (Prop. Treas. Reg. Section 1.1400Z-2(d)-1(b)(4)). This rule, combined with the reasonable working capital safe harbor discussed below and in our previous client alerts, can provide an OZ fund with a capital deployment period that is as long as 43 months. For example, a previously existing calendar-year OZ fund that raises capital on January 2 could disregard the capital until July 2 and, therefore, would not be required to include the capital in its June 30 asset test. On December 30 (the day before its next asset testing date) the OZ fund could contribute the capital into a QOZB, which would have 31 months to use the capital under the reasonable working capital safe harbor. This would give the OZ fund 43 months to deploy the capital, as depicted in the following timeline (dates for illustration only):

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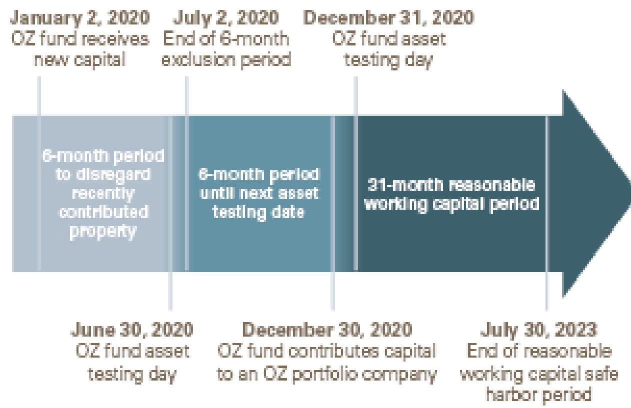

OZ Fund Partnership Liabilities Increase Outside Basis of OZ Fund Partnership Interests

The OZ regime encourages new development of real estate, as well as the rehabilitation of existing structures. It is common for a property-owning partnership engaged in such a project to refinance the project upon stabilization to repay acquisition and construction loans and distribute excess cash to investors. Ordinarily, such a leveraged distribution does not give rise to investor-level gain because each investor's basis in its partnership interest will generally include its share of the partnership's liabilities, such that the cash distributed to an investor will generally not exceed the investor's basis in its partnership interest. In addition, the additional basis increase attributable to the partnership's debt typically allows an investor to take depreciation deductions in excess of its investment in the partnership.

The OZ statute, however, states that an investor's basis in its OZ fund interest is initially zero and is adjusted upwards only after certain holding period requirements are satisfied. Although Congress clearly contemplated that an OZ fund could be formed as a partnership and could invest in lower-tier partnerships, neither the statute nor the initial proposed regulations addressed how the general rules of partnership taxation, including the rules that determine an investor's basis in an OZ fund partnership interest, would apply. As a consequence, it was unclear whether, prior to the time at which an investor's basis in its OZ fund interest is stepped up under the OZ rules, leveraged distributions made by an OZ fund partnership would cause its investors to recognize gain and depreciation deductions that might otherwise be enjoyed would be deferred or disallowed.

The new proposed regulations generally eliminate these uncertainties and provide that an investor's basis in an OZ fund partnership interest is increased by its share of the OZ fund partnership's liabilities (including liabilities allocated to the OZ fund by a partnership in which the OZ fund is a partner), just as it would be outside the OZ regime (Prop. Treas. Reg. Section 1.1400Z-2(b)-1(g)). This basis increase, in most cases, should be sufficient to allow an investor in an OZ fund partnership to avoid gain recognition as a result of its allocable share of the OZ fund partnership's leveraged distributions and to enjoy depreciation deductions as it otherwise would under the partnership tax regime.

The beneficial rules for partnership distributions are subject to an important caveat: a distribution made by an OZ fund partnership will cause an investor to recognize gain and cause an investor's interest in the OZ fund to lose its status as a qualifying OZ fund investment if the distribution, together with the investor's contribution to the OZ fund, is characterized as a disguised sale (Prop. Treas. Reg. Section 1.1400Z-2(a)-1(b)(10)(ii)(A)(2)). For these purposes, any cash contributed by the investor is treated as non-cash property (thus potentially subject to the disguised sale rules) and the exception to disguised sale treatment for leveraged distributions is unavailable. Accordingly, as a practical matter, leveraged distributions that occur within two years of an investor's contribution to an OZ fund partnership will be treated as a disguised sale, causing the investor to recognize gain and disqualifying all or a portion of its interest as a qualifying OZ fund investment. Conversely, leveraged distributions occurring two years after the investor's contributions should not result in disguised sale treatment.

An investor in an OZ fund organized as a C corporation, an S corporation, or a REIT will generally not enjoy similar benefits because the investor's basis in its OZ fund interest will not be adjusted for debt incurred at the OZ fund level or below. As a consequence, investors that prioritize leveraged distributions and depreciation deductions will likely prefer OZ fund partnerships for real estate development projects.

Reasonable Working Capital Safe Harbor Expanded

As described above and in our prior client alerts, the statute imposes strict limitations on the amount of cash and cash equivalents that both OZ funds and QOZBs may hold. At the QOZB level, however, the limitations do not apply to ''reasonable'' working capital. The initial proposed regulations clarified that the amount of working capital maintained by a QOZB would be deemed to be reasonable if the following requirements were satisfied:

1. The amount is designated in writing for the acquisition, construction and/or substantial improvement of tangible property within the opportunity zone;
2. The QOZB prepares a written schedule that provides for the expenditure of the amount within 31 months of the QOZB's receipt thereof and is consistent with the ordinary start-up of a trade or business; and
3. The working capital assets are actually used in a manner that is ''substantially consistent'' with the previous two requirements.

Although helpful with respect to amounts necessary for the acquisition and improvement of tangible property, this initial version of the safe harbor failed to provide guidance with respect to amounts necessary for other business expenses, such as payroll, which was of particular concern for OZ funds engaged in businesses other than real estate development. For example, QOZBs in the services or technology industries may require significant working capital to fund the formation, acquisition, or expansion of a business and to pay employees and contractors pending revenue sufficient to cover expenses.

The new proposed regulations alleviate this concern by expanding the safe harbor to include working capi-

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tal used for the development of any trade or business in an opportunity zone, including amounts necessary for hiring staff and acquiring intangibles, such as permits (Prop. Treas. Reg. Section 1.1400Z-2(d)-1(d)(5)(iv)(A)).

The new proposed regulations also identify circumstances in which deviation from the written schedule is permissible. Specifically, exceeding the 31-month safe harbor period will not violate the safe harbor if the delay is attributable to a delay in government action on an application, as long as the application was completed during the 31-month period (Prop. Treas. Reg. Section 1.1400Z-2(d)-1(d)(5)(iv)(C)). Although this addition is welcome, it is not entirely clear whether relief is available if, for example, a QOZB knows that a certain government action generally takes no less than 12 months while subsequent construction is likely to take another 20 months. This rule also does not address other legitimate deviations from the plan (*e.g.*, natural disasters, disruption in the credit markets, labor market unrest, etc.).

Finally, the new proposed regulations clarify that the same QOZB can benefit from multiple overlapping or sequential reasonable working capital safe harbor plans (Prop. Treas. Reg. Section 1.1400Z-2(d)-1(d)(5)(iv)(D)). This is particularly helpful for real estate developers seeking phased developments and businesses that wish to capitalize on opportunities to pursue new lines of business.

It is worth emphasizing that the reasonable working capital safe harbor continues to apply only at the QOZB level. Accordingly, an OZ fund cannot hold more than 10% of its assets in cash and other nonqualifying assets.

Rules Regarding Leased Tangible Property and Related-Party Leases Clarified

The statute provides that a corporation or partnership will qualify as a QOZB if, among other things, substantially all of the tangible property ''owned *or leased*'' by the entity is ''qualified opportunity zone business property'' (QOZBP) (Section 1400Z-2(d)(3)(A)(i)). This language leaves little doubt that a QOZB is permitted to lease tangible property. Such property clearly will not be a ''good'' asset, however, unless it constitutes QOZBP. Under the statute, tangible property will not qualify as QOZBP unless (1) it is acquired by purchase from an unrelated party after Dec. 31, 2017, (2) its original use in the opportunity zone begins with the QOZB or the QOZB substantially improves the property, and (3) during substantially all of the QOZB's holding period for the property, substantially all of its use is in the opportunity zone. Because leased property is, by definition, not acquired by purchase and because the original use of leased property located inside an opportunity zone will generally begin with the lessor (who placed the property in service), it was not clear how leased property could satisfy these requirements. Because much of the property used in businesses is leased and not purchased, clarity on this point was critical.

Fortunately, the new proposed regulations provide practical guidance. Leased tangible property will generally qualify as QOZBP if four criteria are satisfied: (1) the taxpayer must enter into the lease for the tangible property after Dec. 31, 2017, (2) during substantially all (90% or more) of the period for which the OZ fund or QOZB leases the tangible property, substantially all (70% or more) of the use of the leased property must be in the opportunity zone, (3) the terms of the lease must reflect arm's-length terms, and (4) for real property (other than unimproved land), there cannot exist, at the time the lease is entered into, a plan, intent, or expectation that the OZ fund will purchase the property for other than fair market value determined at the time of purchase and without regard to prior lease payments (Prop. Treas. Reg. Sections 1.1400Z-2(d)-1(c)(4)(i)(B), 1.1400Z-2(d)-1(d)(2)(i)(B)).

The new proposed regulations explicitly permit related-party leases, which is especially helpful for investors that already own property in an opportunity zone and wish to lease that land into an OZ fund or QOZB in which the investor owns an interest. Such leases are subject to certain additional requirements, however. Specifically, in the case of a related-party lease, (1) the lessee (OZ fund or QOZB) may not make prepayments in connection with the lease relating to a period of use of the property that exceeds 12 months and (2) in the case of a lease of tangible *personal* property, the lessee must become owner of tangible QOZBP with a value at least equal to the value of leased tangible personal property before the earlier of the last day of the lease or 30 months after receiving the property under the lease. The latter requirement applies only if the original use of the leased tangible personal property in the opportunity zone did not begin with the lessee (Prop. Treas. Reg. Sections 1.1400Z-2(d)-1(c)(4)(i)(B)(3), 1.1400Z-2(d)-1(d)(2)(i)(B)(3)).

Finally, the new proposed regulations provide rules for determining the value of leased property for purposes of the 90% asset test at the OZ fund level and the 70% QOZBP asset test at the QOZB level. Like purchased property, leased tangible property may be valued as reported on an applicable financial statement prepared according to GAAP, but only if GAAP requires recognition of the lease. Alternatively, a taxpayer may treat leased tangible property as having a value equal to the sum of the present values of all payments to be made under the lease, discounted at the applicable federal rate. A taxpayer must apply its chosen method consistently across all of its leased property (Prop. Treas. Reg. Sections 1.1400Z-2(d)-1(b), 1.1400Z-2(d)-1(d)(3)(ii)).

'Substantial Improvement' Determined on an Asset-by-Asset Basis

Under the statute, if tangible property has been previously used in an opportunity zone, such property cannot constitute QOZBP unless it has been substantially improved, *i.e.*, the OZ fund or the QOZB must, within 30 months, make capital improvements to the property in amounts greater than its initial tax basis in the property. Under the new proposed regulations, the substantial improvement requirement must be applied to purchased tangible property on an asset-by-asset basis (Prop. Treas. Reg. Sections 1.1400Z-2(d)-1(c)(8)). Thus, for example, if an OZ fund acquires four buildings for \$100x each as part of a single project, it must double the tax basis of each and every building it needs to qualify as QOZBP. This is so even if, from a commercial perspective, it would make sense to invest an aggregate of

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$401x in only one or two of the buildings. As a consequence, the asset-by-asset approach may discourage investments that would otherwise represent the most efficient use of capital. It can also be onerous and impractical, especially for operating businesses with significant and diverse assets, a concern explicitly acknowledged in the preamble. In fact, Treasury and the IRS requested comments on this point, including whether a group of interrelated tangible assets should be aggregated as a single asset for purposes of the substantial improvement requirement.

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