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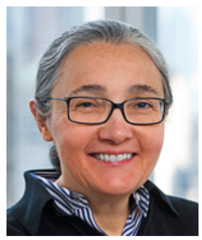
INSIGHT: Second Wave of Opportunity Zone Guidance Addresses Many Key Issues, Leaves Open Questions for Future Guidance (PART 2)



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The new proposed regulations address a number of concerns left unanswered by the initial proposed regulations and establish a sensible framework under which many investors should be able to move forward with opportunity zone projects.

Part 1 discussed the recently issued second set of proposed opportunity zone regulations. Part one includes an explanation of the 90% test, partnership basis issues, and the working capital safe harbor.

Active Trade or Business Requirement Clarified

The statute requires that a qualified opportunity zone business (QOZB) derive at least 50% of its gross income from the active conduct of a trade or business in an opportunity zone and that it use a substantial portion of its intangible assets in such trade or business. Similarly, tangible property must be used in a trade or business to qualify as qualified opportunity zone business property (QOZBP). Yet neither the statute nor the initial proposed regulations define ''trade or business'' (or the active conduct thereof) for these purposes. As a consequence, it was not clear whether businesses historically considered passive under the tax law, such as certain real estate leasing businesses, could satisfy these requirements.

The new proposed regulations provide guidance by clarifying that ''trade or business'' generally has the same meaning in the opportunity zone context as it has for other purposes of the tax code (Prop. Treas. Reg. Sections 1.1400Z-2(d)-1(d)(2)(ii)). Although the determination whether an activity is a trade or business under other code sections is highly fact-dependent and can, in many cases, be uncertain, the new proposed regulations helpfully provide that, for purposes of the tax code Section 1397C requirements incorporated into the definition of ''qualified opportunity zone business,'' the ownership and operation (including leasing) of real property constitutes the active conduct of a trade or business (Prop. Treas. Reg. Sections 1.1400Z-2(d)-1(d)(5)(ii)(B)(2)). Under this rule, ownership and operation of real property requires something more on the part of the taxpayer than ''merely entering into a triple-net-lease,'' but the regulations provide little insight as to the level of activity required to distinguish a ''good'' lease from a triple-net- lease for these purposes, other than implying existing law on triple-net-leases applies.

Three Safe Harbors Provided for the 50% Gross Income Test

Under the statute, a QOZB must derive at least 50% of its gross income from the active conduct of trade or business within an opportunity zone, but neither the statute nor the initial proposed regulations provide any rules on how to determine whether the requirement is satisfied. The lack of guidance caused uncertainty regarding whether operating businesses located inside an opportunity zone could derive ''good'' income from services or products delivered to customers located outside the zone.

The new proposed regulations provide three safe harbors under which a QOZB will be deemed to satisfy the 50% gross income test:

1. At least 50% of the services performed by employees and independent contractors, based on hours, are performed within the opportunity zone;

2. At least 50% of the services performed by employees and independent contractors, based on the amounts the QOZB pays for such services, are performed in the opportunity zone; or

3. The tangible property of the business in the opportunity zone and the management or operational functions performed for the business in the zone are each necessary to generate at least 50% of the gross income of the business.

If none of these safe harbors apply, the determination is made based on all the facts and circumstances (Prop. Treas. Reg. Sections 1.1400Z-2(d)-1(d)(5)(i)).

Although it is useful to understand that the 50% gross income test can be satisfied based on hours worked and amounts paid, there is no guidance on how to determine whether services will be treated as performed within an opportunity zone or which types of service providers will qualify as independent contractors (rather than vendors) under these rules. For example, it is not clear whether a QOZB is required to treat amounts paid for third-party data-center or tech-support services provided from outside the opportunity zone as ''bad'' in its safe harbor calculations, nor is it clear whether the relationship between a QOZB and a data-center operator is one of customer and service provider or tenant and landlord. The rules also fail to prescribe standards for tracking hours worked and amounts paid for safe harbor purposes and it is not clear how, as a practical matter, such data is to be obtained from independent third-party vendors and service providers.

For example, will QOZBs subject service providers to cumbersome and off-market record-keeping and reporting requirements? What about employees of a QOZB that sometimes work remotely or respond to emails while traveling? What if a QOZB operating in an opportunity zone hires an agency to advertise its business outside the zone? Without additional guidance, neither of the first two safe harbors can be relied upon without significant analysis regarding whether and the extent to which meaningful services provided by anyone outside the opportunity zone must be taken into account. To avoid these issues, many OZ funds will likely prefer to rely on the third safe harbor, which, in the first instance, may be best suited for OZ funds in the real estate industry.

New Capital Redeployment Rules Provide 12-Month Reinvestment Period

The statute directs Treasury to provide rules allowing an OZ fund a reasonable period of time to reinvest the proceeds from the sale or disposition of QOZP. In response, the new proposed regulations provide that, for purposes of the 90% asset test, any such proceeds will be treated as QOZP as long as they are reinvested in QOZP within 12 months after the OZ fund's receipt thereof and, prior to reinvestment, the proceeds are held in cash, cash equivalents, or short-term debt instruments (Prop. Treas. Reg. Sections 1.1400Z-2(f)-1(b)). As in the working capital safe harbor provisions, the regulations grant relief if a failure to meet the 12-month deadline is attributable to a delay in government action if the application for the action was completed during the 12-month period. Combining the 12-month reinvestment period with the 31-month working capital safe harbor, as well as the fact that an OZ fund's 90% asset test is tested every six months, could provide up to 49 months for capital redeployment.

Note, however, that this reinvestment rule does not defer the recognition of gain on the assets sold, as [Section 1031] would, for example. Thus, the OZ fund (and, in the case of an OZ fund that is a partnership or a REIT, its investors) will recognize the gain notwithstanding the reinvestment. Because the most salient tax benefit offered by the OZ legislation is the OZ tax exemption, and because any capital redeployment is likely to occur prior to 2028 (when all OZ designations expire), this provision likely will not be useful for appreciated QOZP, although it will certainly help OZ funds redeploy capital out of losing investments.

Narrowing of Potential 'Inclusion Events'

Under the statute, an OZ fund investor must include its deferred gain in income on the earlier of (1) the date on which the investment is sold or exchanged or (2) Dec. 31, 2026. Because the tax law defines ''exchange'' to include a wide variety of transactions in which property is moved from one regarded entity to another, there was concern that routine transactions, such as holding company formations and intragroup restructurings, might result in the acceleration of deferred gain and loss of the OZ tax exemption. The new proposed regulations address this concern by identifying those transfers that will be treated as ''inclusion events,'' those that will not be treated as inclusion events, and those that will allow the transferee to step into the shoes of the transferor with respect to the OZ tax exemption (Prop. Treas. Reg. Sections 1.1400Z-2(b)-1(c)).

Except in certain cases where the transaction would otherwise be tax-free, an inclusion event will generally occur when an OZ fund investor cashes out or reduces its equity interest in the OZ fund. Notably, distributions (even *pro rata* distributions) from an OZ fund in excess of basis can be inclusion events that accelerate an investor's deferred gain. This rule seems particularly harsh in the case of *pro rata* distributions of operating cash flow by OZ fund corporations, given that the OZ asset tests restrict the ability of OZ funds and QOZBs to hold cash.

Transactions that are not inclusion events include, for example, the contribution of an OZ fund interest to a partnership in exchange for a partnership interest, certain mergers involving OZ funds and entities that own interests in OZ funds, and certain corporate spin-offs. The rule that permits an OZ fund corporation to divide into two OZ funds would not appear to apply to OZ fund partnerships, although it is not clear whether this omission (if it exists) was intentional.

With one notable exception, transfers of corporate stock and partnership interests generally do not create adverse results for lower-tier entities that either hold or are classified as OZ funds. The exception applies in the context of transfers of interests in S corporations that directly own interests in OZ funds. If such a transfer results in a greater than 25% change of ownership in the

S corporation, then the S corporation must recognize all of its deferred gain and will lose the ability to enjoy the OZ tax exemption. Unless this rule is changed, holding an OZ fund interest at the S corporation level would seem to be ill-advised, and S corporation shareholders experiencing gain through the S corporation itself should consider making their OZ fund investment outside the S corporation chain.

The transfer of an OZ fund interest by reason of an investor's death also is not an inclusion event, nor is the contribution of an OZ fund interest to a grantor trust deemed to be owned by the transferor. In each such case, the transferee's holding period for the OZ fund interest will include that of the transferor, which apparently means the transferee will be eligible to enjoy the OZ tax exemption if it completes the 10-year holding period. The pre-death conversion of a grantor trust into a complex trust, or vice versa, is an inclusion event; whereas the conversion of a grantor trust into a complex trust at the grantor's death is not. The basis of an OZ fund interest is not stepped-up to its fair market value upon a transfer at death; accordingly, any gain deferred at the time of the original investment (reduced by basis adjustments under the OZ regime and any portion of such gain previously taken into account) will be includible by the transferee as income in respect of a decedent on the earlier of (1) the date on which the OZ fund interest is sold or exchanged or (2) Dec. 31, 2026.

Given the disparities in the treatment of transfers of different types of OZ funds to and among different types of business and trust entities, whether an inclusion event has occurred and the consequences thereof will depend on not only the structure of the OZ fund, but also on the level in the investor's ownership chain at which the OZ fund investment is made and the entity classification of the vehicle used to make the investment. Accordingly, the structure of an OZ fund investment continues to be paramount for maximizing the benefits of the OZ fund regime and should be carefully considered at the outset.

Secondary Market Acquisitions of OZ Fund Interests Eligible for OZ Tax Exemption

The statute and the initial proposed regulations are silent as to whether an otherwise eligible investor can avail itself of the OZ tax exemption with respect to an OZ fund interest purchased on the secondary market (as distinguished from an OZ fund interest acquired at original issuance from the OZ fund itself). This raised concerns that selling an OZ fund interest on the secondary market would be difficult, which, in turn, complicated marketing efforts. It also prevented sponsors from warehousing OZ fund interests prior to syndication, which complicated the formation of OZ funds and the development of QOZBs.

The new proposed regulations address these issues by allowing an investor to make a gain deferral election on the acquisition of an OZ fund interest from a person other than the OZ fund, which may facilitate OZ fund investments where eligible gains are recognized only after an OZ fund has been closed and capitalized, whether by seed investors or by a sponsor (Prop. Treas. Reg. Sections 1.1400Z-2(a)-1(b)(9)(iii)). The purchaser would not inherit the seller's holding period, however, which, in certain cases, might deny the purchaser the opportunity to satisfy the 10-year holding period requirement before the OZ fund experiences a liquidity event. For example, a sponsor may plan for a liquidity event to occur shortly after the 10th anniversary of the final capital contribution to its OZ fund. In this circumstance, a secondary market purchaser that acquires an interest after the date of the final capital contribution might assume the risk that the liquidity event will occur less than 10 years after the beginning of the purchaser's holding period.

Conclusion

Questions left unaddressed by the initial proposed regulations caused many investors to slow or even table investments in OZ funds. In the new proposed regulations, Treasury and the IRS pragmatically addressed a number of their concerns and established a sensible framework under which many such investors will likely feel comfortable enough to move forward. We are encouraged by the realistic and policy-orientated approach Treasury and the IRS have been taking with respect to the OZ regime, and, although there are still some issues left to be resolved, we believe the regulations to date provide investors a solid path forward as they await further favorable guidance and clarity.

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