



At Last, More Guidance on Qualified Opportunity Zones, But Questions Still Remain

On April 17, 2019 the U.S. Department of Treasury issued the second round of proposed regulations to clarify the rules related to the Qualified Opportunity Zones (QOZs). These proposed regulations refine the application of Section 1400Z-2 of the Internal Revenue Code (the Code) and update the proposed regulations previously issued in October 2018. The proposed regulations:

- 1) Define the term “substantially all” for purposes the qualifying amount of property to be held by a Qualified Opportunity Zone Business (QOZB) and qualifying holding periods;
- 2) Describe the transactions that prematurely trigger gain recognition otherwise deferred by investment in QOZs;
- 3) Explain how to determine both the timing and amount of deferred gain to be recognized; and
- 4) Address how leased property used by a QOZB will be treated.

The following is a summary of some of the new rules found in the proposed regulations.

1) The definition of “substantially all” is still 70 percent for determining use of tangible property but is 90 percent for holding periods.

To qualify as a QOZB under the Code, “substantially all” of the tangible property owned or leased by the trade or business must be QOZ business property, as that term is defined in the Code. The October 2018 proposed regulations clarified that, for purposes of determining whether a partnership or corporation whose equity interests were owned by a Qualified Opportunity Fund (QOF) was a QOZB, the term “substantially all” meant at least 70 percent.

This was helpful but did not address the other uses of the phrase “substantially all” found in Section 1400Z-2. In particular, the definition of QOZ business property utilized this term twice, once to describe the amount of the property’s use by a QOF that must occur in a QOZ and once to describe the period of time over which the QOF must hold the property. As stated above, the October 2018 regulations provided guidance on the former but not the latter. There are more occasions when the term “substantially all” describes a holding period.

These new proposed regulations now confirm that the term “substantially all” still means 70 percent in the contexts related to use but a 90 percent threshold is imposed in the holding period context. In other words, to qualify as QOZ business property, 70 percent of the property’s use by the QOF must occur in a QOZ and this qualifying use must occur during 90 percent of the QOF’s holding period for such property.

2) The term “substantial portion” means 40 percent for determining use of intangible property

The newly proposed regulations provide guidance related to the term “substantial portion.” The term substantial portion is used to determine whether an entity owned by a QOF qualifies as a QOZB. In particular, for an entity to qualify as a QOZB, 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. For this purpose, the term “substantial portion” means at least 40 percent.

3) Inventory in transit is still tangible property used in the QOZ.

Some taxpayers were worried that the time inventory was in transit from a vendor or a customer to a QOZ facility would not count towards the qualifying use requirement for QOZ business property because the inventory’s use was not always physically in the QOZ. Happily, the proposed regulations clarify that inventory, including raw materials, do not fail to be used in a QOZ solely because they are in transit from a vendor or to a customer not located in a QOZ for part of the time they are owned by the QOF. The IRS and Treasury’s position on this issue do not appear settled, however. Follow-up comments have been requested on whether the location of a warehouse should be relevant to determining use of inventory, among other issues.

4) Leased property has no original use or substantial improvement requirement, but there are some related party issues to navigate.

The proposed regulations clarify that leased tangible property can be treated as QOZ business property for purposes of satisfying the QOF 90 percent test or the

QOZB 70 percent/substantially all test in most cases if the following requirements are satisfied:

- a. The leased tangible property must be acquired under a lease entered into after December 31, 2017;
- b. Substantially all of the use of the leased tangible property must be in a QOZ during substantially all of the holding period for which the business leases the property; and
- c. The lease under which the lessee QOF or QOZB acquires rights must be a market rate lease.

Note that these requirements do not impose any original use requirement or substantial improvement requirement on leased tangible property. However, if the lessor is related to the lessee QOF or QOZB, two additional requirements are imposed. First, where the QOF or QOZB lessee is related to the lessor, the QOF or QOZB cannot make a prepayment to the lessor relating to the period of use of the leased tangible property that exceeds 12 months. This requirement operates to avoid improper allocations of investment capital to prepayments of rent. Second, if the original use of leased tangible personal property does not commence with the lessee in the QOZ, the lessee QOF or QOZB must become the owner of the tangible property (QOZ business property that is used in the same zone in which the leased property is used and has a value not less than the value of the leased personal property). The QOF or QOZB needs to acquire this property within 30 months of the date on which the lessee receives possession of the leased property.

5) Original use of QOZ business property in a QOZ is clarified.

Owned tangible property must be acquired by purchase after December 31, 2017 and have its original use in the QOZ or be substantially improved (among other requirements) in order to be QOZ business property. Leased personal property from a related party must have its original use in the QOZ or deal with the 30-month test described above. The proposed regulations now clarify that original use commences on the date on which a person first places the property in service in a QOZ for purposes of depreciation or amortization (or first uses it in the QOZ in a way that would allow depreciation or amortization if the person were the property's owner).

Because of this guidance, it is clear that tangible property in a QOZ that is depreciated or amortized by a taxpayer other than the QOF or the QOZB prior to their receipt of the property will not satisfy the original use requirement. On the other hand, if the first person to acquire tangible property to be used in the QOZ and depreciate/amortize it is the QOF or the QOZB, this will satisfy the original use requirement. Used tangible property satisfies the original use requirement if it was not previously used within that QOZ in a manner that would have allowed it to be depreciated/amortized by any taxpayer.

Also, the proposed regulations provide additional guidance in the real property situation for QOFs and QOZBs working with vacant or unimproved land. Specifically, they state that if a building or structure in a QOZ has been vacant for at least five years, the purchased building or structure will satisfy the original use requirement. For unimproved land (e.g., potential farmland), the proposed regulations also give guidance. They state that unimproved land that is acquired by purchase in a QOZ is not required to be substantially improved in order for it to be QOZ business property if all other requirements are met. In this manner, a QOF's acquisition of farmland for production of a crop could be treated as QOZ business property without requiring the QOF to invest a significant amount of additional capital therein to improve the land and increase its output.

Finally, lessee improvements to leased property satisfy the original use requirement up to the unadjusted cost basis under Code Section 1012.

6) QOFs are given time to reinvest the return of capital from QOZ property.

A QOF is defined as “any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in QOZ property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in QOZ property....” The proposed regulations provide that proceeds received by a QOF from the sale or disposition of QOZ property (including QOZ stock, partnership interests or QOZ business property) are still treated as QOZ property for purposes of the 90 percent test as long as they are reinvested in QOZ property within 12 months of the sale or disposition and they are continuously held during such period in the form of cash, cash equivalents and/or short-term debt instruments. The Department of Treasury is still considering whether to create an analogous rule for QOF subsidiaries and has requested comments from practitioners on that issue.

7) Guidance provided on whether certain dispositions of a QOF interest will trigger taxation of deferred capital gain.

According to the Code, deferred capital gains are taxed on the earlier of either the date of the sale or disposition of the QOF investment or December 31, 2026. The proposed regulations clarify that the term disposition includes any transfer of a qualifying QOF investment in a transaction to the extent that the transfer reduces the person's equity interest in the QOF, except for a few specifically exempted transactions. These may include:

- a. Transfers in which the person receives property from the QOF as a distribution for federal tax purposes (e.g., a dividend or a partnership non-liquidating distribution);
- b. Transfers from an estate to a beneficiary following the death of the QOF investor;

- c. Transfers to a grantor trust or other disregarded entities that are not separate from the investor.

Thus, gain trigger events may include, among other transactions, charitable donations and gifts of QOF interests, redemptions of QOF stock, distributions from a QOF partnership in excess of the partner's basis in the QOF partnership interest and various reorganizations of QOF corporations. Be wary if you undergo a transaction like this and consult the proposed regulations to see if it is taxable.

8) **Guidance on what constitutes the active conduct of a trade or business; some land can be located outside of the QOZ and still qualify.**

The proposed regulations clarify that the term “active conduct of a trade or business” for purposes of the QOZ rules will refer to Code Section 162. As such, land is QOZ business property only when it is used in a trade or business within the meaning of Code Section 162. Specifically, owning land for investment purposes does not give rise to a trade or business in and of itself. If land is simply held by a QOF or QOZB for investment and is not utilized in some productive manner in connection with the QOF or QOZB's active business, such land is not QOZ business property. The proposed regulations do clarify, however, that the ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business.

In addition, for purposes of satisfying the requirements under Code Section 1400Z-2 and 1397C(b)(2) (i.e., 50 percent gross income test), Code Section 1397C(b)(4) (i.e., intangible property test), and Code Section 1397C(b)(8) (i.e., minimal nonqualified financial property test), the proposed regulations provide new rules for land contiguous to a QOZ. If the amount of real property based on square footage within a QOZ is substantial when compared to real property outside of the QOZ that is contiguous to and/or part of the QOZ real property, all of the real property will be deemed to be located within the QOZ. For this purpose, there is substantiality for purposes of satisfying the requirements when the unadjusted cost of real property inside the QOZ is greater than the unadjusted cost of real property outside of the QOZ.

9) **Substantial improvement of tangible property is measured on an asset-by-asset basis.**

Under the proposed regulations, when an asset is substantially improved (related to qualification as QOZ business property) is determined on an asset-by-asset basis. This seems somewhat impractical depending on the number and type of assets. As such, the Treasury has requested comments on how an aggregate approach might be applied to determine substantial improvement.

10) Guidance provided for determining when a QOZB will be treated as deriving at least 50 percent of its total gross income from the active conduct of a trade or business in a QOZ.

QOZBs are required to derive at least 50 percent of their total gross income from the active conduct of a trade or business located in a QOZ. The rule caused confusion for operating businesses who had customers outside of the zone (e.g., if you sold products online or made products in the QOZ but had salespeople selling them to customers outside of the QOZ). The proposed regulations provide three default options for passing the 50 percent gross income test:

- a. At least 50 percent of the services in a tax year performed by employees and contractors (based on hours) are performed within the QOZ;
- b. At least 50 percent of the services in a tax year performed by employees and contractors (based on amounts paid for services performed) are performed within the QOZ; or
- c. The tangible property of the QOZB (that is in the QOZ) and the management or operational functions performed (for the QOZB in the QOZ) are each necessary to generate 50 percent from the gross income of the QOZB's trade or business.

If a QOZB does not fall under one of the default options above, the QOZB can still meet the 50 percent gross income test if (based on facts and circumstances) at least 50 percent of the gross income is derived from the active conduct of a trade or business in the QOZ.

11) Guidance provided on QOF investment basis, basis step-ups and how to leave a QOF partnership entity after the 10-year holding period has run.

The Code states that an investor initially has a \$0 basis in the QOF investment. The proposed regulations provide new guidance on how this rule works in practice when built-in gain or built-in loss property is contributed to a QOF partnership in exchange for an interest in the QOF. They also shed light on how to determine whether the interest an investor receives back is a qualifying QOF investment or a non-qualifying QOF investment. Finally, the preamble to the proposed regulations discuss what the \$0 basis means for pass-through losses from the QOF that may be suspended under Code Section 704(d), noting that a tax loss that is suspended under Code Section 704(d) will be freed when the taxpayer has additional basis in its QOF interest. This could occur when the QOF has income to offset or when the basis step-ups happen in years five and seven.

When it comes to the 10-year holding period step-up in basis to fair market value (FMV), the proposed regulations clarify that an investor's FMV basis step-up after the 10-year holding period will apply immediately before the investor sells the QOF investment. For partnerships and S corporation QOFs, an investor's basis

Qualified Opportunity Zone Fund Investments



Thomas J. Hillegonds
Grand Rapids
616/336-6442
tjhillegonds@varnumlaw.com



Katie K. Roskam
Grand Rapids
616/336-6494
kkroskam@varnumlaw.com



Fred L. Schubkegel
Kalamazoo
269/553-3514
flschubkegel@varnumlaw.com



Mary Kay Shaver
Grand Rapids
616/336-6755
mkshaver@varnumlaw.com

is adjusted to FMV after the 10-year holding period and the basis of the QOF's assets are also adjusted. This avoids hot asset issues, along with the creation of capital losses and ordinary income on the sale of the QOF interest. In addition, if a taxpayer has held a QOF investment in a QOF partnership or S corporation for at least 10 years when the QOF disposes of its QOZ property, the investor can make an election to exclude from gross income some or all of the capital gain arising from such disposition on Schedule K-1 of the QOF and attributable to the qualifying investment. This may answer some questions about how asset sales are treated in a QOF.

12) Timing for more guidance from the IRS and Treasury.

The introduction to the proposed regulations clearly states that the IRS and Treasury expect to provide more guidance on QOZs within the next few months. Expect that Form 8996 (used for initial QOF self-certification and annual reporting) will be revised for the 2019 tax year and beyond. The IRS and Treasury have also stated that they continue to seek information and comments on the QOZ rules.

Notwithstanding the guidance given in the latest proposed regulations, many questions remain. With respect to the reinvestment rule for QOFs, the IRS and Treasury are asking for comments on whether a similar rule should be provided for QOZBs, or whether QOFs and their investors should be exempt from the federal income tax consequences of selling QOZ property if such dispositions are reinvested in QOZ property within a reasonable timeframe. Hopefully, the IRS and Treasury will provide additional guidance soon.

This memorandum is provided by Varnum LLP for educational and informational purposes only. It is not intended and should not be construed or relied upon as legal or tax advice. A taxpayer's ability to claim tax benefits depends on the individual taxpayer's circumstances. No tax benefits are guaranteed as a result of investing in a Qualified Opportunity Fund. Potential investors should consult their tax advisers with respect to the U.S. federal income tax consequences of an investment in a Qualified Opportunity Fund.