

April 22, 2019

Second Set of Qualified Opportunity Zone Fund Proposed Regulations Issued

On April 17, 2019 the Internal Revenue Service released the long-anticipated second set of proposed regulations (the Additional Regulations) supplementing, and in some instances replacing, guidance provided in its initial proposed regulations released on October 29, 2018 (the Initial Regulations) with respect to qualified opportunity funds (QOF) under Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code (Code). The Additional Regulations provide some much needed clarity on issues such as:

- applicable use and holding period standards for QOF assets,
- the “original use” standard for property in a QOZ,
- treatment of property leased by a QOF,
- sourcing of gross income of a QOF, and
- the period within which a QOF can reinvest asset sale proceeds and avoid a penalty for holding disqualifying assets.

The Additional Regulations also provide some unexpected but welcomed flexibility on qualifying contributions of property to a QOF while instituting a complex regime for triggering inclusion of deferred capital gain by a QOF investor.

The Additional Regulations confirm that Code Sections 1400Z-1 and 1400Z-2 seek to encourage economic growth and investment in designated qualified opportunity zones (QOZ) by providing income tax benefits to taxpayers investing new capital in businesses located within QOZs through a QOF.

However, the Additional Regulations did not provide expected guidance on the standard for an “active” trade or business within a QOZ.

Because the Additional Regulations are voluminous and cover numerous areas of concern for investors, we will address the guidance in the proposed regulations in two Alerts. This first Alert analyzes QOF and QOZ business qualifications issues addressed in the Additional Regulations. The second Alert will analyze QOF investor and taxpayer issues addressed in the Additional Regulations.

QOF AND QOZ BUSINESS QUALIFICATION ISSUES

The substantially all standards. The Initial Regulations provide that at least 70% of a QOZ Business’ owned or leased property must be QOZ Business Property to meet the requirement that substantially all of the QOZ Business’ property be QOZ Business Property. The Additional Regulations further clarify that:

(1). for property to be treated as QOZ Business Property, during at least 90% of the period a QOF or QOZ Business holds QOZ Business Property, at least 70% of the use of such QOZ property must be in a QOZ;

(2). for stock or partnership interests held by a QOF to qualify as QOZ Stock or QOZ Partnership Interests, during at least 90% of the period a QOF holds QOZ Stock or QOZ Partnership Interests, the underlying corporation or partnership must qualify as a QOZ Business;

In summary, the Initial Regulations and Additional Regulations clarify that 70% is the applicable “substantially all” standard with respect to the use of QOZ Business Property in a QOZ, while 90% is the applicable “substantially all” standard with respect to the holding period of QOZ Business Property, QOZ Stock and QOZ Partnership Interests.

Leased property. The Additional Regulations provide much needed flexibility for leased tangible property, confirming that QOZ Business Property can be owned or leased by a QOF or QOZ Business, and that leased tangible property need not satisfy an “original use” requirement or be substantially improved. Instead, leased tangible property must satisfy two criteria:

First, leased tangible property must be acquired under a lease entered into after December 31, 2017;

Second, substantially all (70%) of the use of the leased tangible property’s use must be in a QOZ during substantially all (90%) of the period the QOF or QOZ Business leases the property.

In addition, the Additional Regulations provide that, unlike purchased tangible property, the QOF or QOZ Business may lease tangible property from a lessor that is related to the QOF or QOZ Business, provided certain requirements are met:

- the lease must be a “market rate lease” reflecting common, arms-length, market practice in the locale that includes the QOZ;
- the QOF or QOZ Business cannot at any time make lease or rent prepayments for more than a 12 month period;
- the QOF/QOZ Business lessee must also purchase and own other QOZ Business Property that has a value equal to or exceeding the value of the leased personal property. The QOF/QOZ Business lessee must acquire the other QOZ Business Property within 30 months of the date the QOF/QOZ Business lessee first receives possession of the leased tangible property and the leased and owned QOZ Business Property must be used in substantially the same QOZs.
- To prevent leases being used to circumvent the substantial improvement requirement for purchases of improved real property, if a QOF/QOZ Business leases improved real

property, there may not be any option, agreement, plan, intent or expectation permitting the QOF/QOZ Business to purchase the improved real property for an amount other than the fair market value of the improved real property determined at the time of the purchase without regard to any prior lease payments.

Valuing leased property. Leased tangible property must be valued for purposes of the 90% holding period and 70% use tests. The Additional Regulations provide leased tangible property may be valued annually using either an applicable financial statement valuation method or an alternative valuation method, with the selected method applied consistently to all leased tangible property for such year.

Original use of property. Code Section 1400Z-2(d)(2)(D)(i)(II) requires that the “original use” of tangible QOZ Business Property, whether purchased or leased, commence in a QOZ by the QOF or QOZ Business, or that the tangible QOZ Business Property be substantially improved by the QOF or QOZ Business. The Additional Regulations provide helpful clarity that “original use” of tangible property begins when the tangible property is first placed in service in the QOZ for purposes of depreciation or amortization (or the property is first used in the QOZ that would allow for it to be depreciated or amortized).

Business Real Property Straddling a QOZ: The Additional Regulations clarify that, based on square footage, if the amount of QOF or QOZ Business real property located within a QOZ is substantial as compared to the amount of real property located outside of the QOZ, and the real property outside of the QOZ is contiguous to part or all of the real property located within the QOZ, then all of the property would be deemed to be located within the QOZ. Real property located within the QOZ is substantial if its unadjusted cost is greater than the unadjusted cost of real property outside of the QOZ.

Inventory in Transit: Section 1400Z-2(d)(2)(D)(i)(III) requires, during substantially all (90%) of the period a QOF or QOZ Business holds QOZ Business Property, that substantially all (70%) use of such property must be in an active trade or business within a QOZ. The Additional Regulations clarify that inventory (including raw materials) of a trade or business is considered used in a QOZ even when the inventory (or raw materials) are in transit from a vendor to the QOZ trade or business, or from the QOZ trade or business to its customers, even if such vendor or customers are outside of the QOZ.

Sourcing of Gross Income of a QOF: Under Code Section 1400Z-2(d)(3)(A)(ii) at least 50% of the total gross income of a QOZ Business must be derived from the active conduct of a trade or business in the QOZ. The Additional Regulations provide three safe harbors plus a fourth facts and circumstances test to satisfy Code Section 1400Z-2(d)(3)(A)(ii). A QOZ Business only needs to meet one of the safe harbors or the facts and circumstances test.

- Safe harbor 1: at least 50% of the services performed (based on hours) for the QOZ Business by its employees and independent contractors (and employees of independent contractors) are performed within the QOZ. (This test is intended to address businesses located in a qualified opportunity zone that primarily provide services.)

- Safe harbor 2: at least 50% of the services performed (based on amounts paid) for the QOZ Business by its employees and independent contractors (and employees of independent contractors) are performed in the QOZ.
- Safe harbor 3: the 50% gross income test is satisfied if (A) the tangible property of the QOZ Business in a QOZ, and (B) the management or operational functions performed for the QOZ Business in the QOZ, are both necessary to generate 50% of the gross income of the QOZ trade or business.
- Facts and circumstances test: QOZ Businesses not meeting any of the safe harbor tests may satisfy the Code Section 1400Z-2(d)(3)(A)(ii) 50% test based on a facts and circumstances test if, based on all the facts and circumstances, at least 50% of the gross income of the trade or business is derived from the active conduct of the trade or business in the QOZ.

Intangibles of a QOZ Business: Under Code Section 1400Z-2(d)(3)(A)(ii) a substantial portion of the intangible property of the QOZ Business must be used in such trade or business. The Additional Regulations provide that a substantial portion means at least 40% of the intangible property of the QOZ Business.

Active Conduct of a Trade or Business Including Leasing Activity: Under Code Section 1400Z-2(d)(3)(A)(ii) at least 50% of the total gross income of a QOZ Business must be derived from the active conduct of a trade or business in the QOZ. The Additional Regulations confirm that a “trade or business” under Code Section 1400Z-2 as contemplated under Code Section 162 and its regulations and interpreting authorities.

Importantly, the Additional Regulations confirm that the ownership and operation (including leasing) of real property that is used in a “trade or business” is treated as the active conduct of a trade or business. However, triple-net leasing will not constitute active conduct of a trade or business.

Reasonable Working Capital Safe Harbor Extension: The Initial Regulations provided a reasonable working capital safe harbor that a QOZ Business can elect to allow up to 31 months to acquire, construct, and/or substantially improve tangible property and develop a trade or business in a QOZ. The Additional Regulations provide an extension of the 31 month period if the delay is attributable to waiting for government action the application for which is completed during the 31-month period.

Newly-Contributed Assets to a QOF: Noting that new capital received by a QOF shortly before its next semi-annual test could pose a problem for the QOF to satisfy the 90% investment requirement under Code Section 1400Z-1(d)(1) and (f), the Additional Regulations provide that a QOF may apply the semi-annual 90% test without taking into account any investments received within the 6 months preceding the test date, provided that the new assets are held in cash, cash equivalents, or debt instruments with term 18 months or less during such six-month period.

Reinvestment of Asset Sale Proceeds by a QOF: To allow a QOF adequate time to reinvest proceeds from a sale of QOZ Property, the Additional Regulations provide that proceeds received by the QOF from the sale or disposition of (A) QOZ Business Property, (B) QOZ Stock, and (C) QOZ Partnership Interests, are treated as QOZ Property for purposes of the 90% investment requirement under Code Section 1400Z-1(d)(1) and (f), so long as:

- (1) the QOF reinvests the proceeds received within 12 months of the date of such sale or disposition, and
- (2) the proceeds are continuously held in cash, cash equivalents, or debt instruments with term 18 months or less until the proceeds are invested in other QOZ Property (which does not need to be the same type of QOZ Property that was sold). This 12-month period may be extended if the delay is attributable to waiting for government action the application for which is completed during the 12-month period.

As stated at the outset, this first Alert focused on QOF and QOZ business qualifications issues addressed in the Additional Regulations. A second Alert will further analyze QOF investor and taxpayer issues addressed in the Additional Regulations.

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