QUALIFIED OPPORTUNITY ZONES: SECOND SET OF PROPOSED REGULATIONS OFFERS GREATER CLARITY TO INVESTORS

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The clock is ticking for "Opportunity Zones," and the I.R.S. is aware. The Opportunity Zone tax benefit, which was crafted as part of the 2017 tax reform, aims to encourage taxpayers to sell appreciated capital properties and rollover the gains into low-income areas in the U.S. One major benefit – reducing recognition of deferred gains by up to 15% – is only available to investments made before the end of 2019, although other benefits will continue to be available to later investments.

While the tax benefits are attractive (see our two prior articles, "The Opportunity Zone Tax Benefit – How Does It Work and Can Foreign Investors Benefit" and "Additional Guidance on New Opportunity Zone Funds"), investors remained reserved as too many questions were left unanswered by the first round of proposed regulations. As a result, the potential of this provision has not been fully utilized as of yet.

Knowing this, in late April, the I.R.S. released a second set of proposed regulations that address many of the issues that were reserved in the prior set of proposed regulations, as well as those that were raised by written comments and at the well attended public hearing conducted in February. Another public hearing is scheduled for July 9, but reportedly, the Treasury is currently not working on a third set of proposed regulations to address any additional unanswered matters. Some of the major issues clarified by the April proposed regulations are discussed below.

BACKGROUND

Added to the Code by the 2017 Tax Cuts and Jobs Act, Code §1400Z-1 provides the criteria for areas to be designated as Opportunity Zones, and Code §1400Z-2 provides for the tax benefits associated with investments in these areas.

Three tax benefits are offered to taxpayers who timely invest rolled-over capital gains into a qualified opportunity zone fund ("Qualified Fund"). These were discussed in detail in our prior publications, and in short, can be described as follows:

- Deferral of gain recognition on taxable events in which capital gain is realized – the deferral is available until the earlier of (i) December 31, 2026, or (ii) a realizing event (as defined below)
- Reduction (exclusion) of up to 15% of the inclusion amount of the deferred gain upon recognition – investments held for five years may benefit from a reduction of 10% whereas investments held for seven years may benefit from the full 15%
- Exclusion of the entire post-acquisition gain for investments held for at least ten years

Dispositions after 2019 will not benefit from the full 15% reduction in gain recognition but only 10%, and dispositions after 2021 will not benefit from any reduction in gain recognition. Dispositions of property as late as 2026 (and timely reinvestment by as late as June 30, 2027) may still benefit from an exclusion of post-acquisition gain after a ten-year holding period (but not beyond 2047).[1]

RULES RELATING TO THE QUALIFIED FUND

The proposed regulations clarify many issues relating to the qualification as a Qualified Fund. The following only touches on some of those issues, with the goal of providing potential investors with the general lay of the land.

The 90% Investment Standard Test for a Qualified Fund

A fund (formed as a corporation or a partnership)[2] will be treated as a Qualified Fund if 90% or more of the fund's assets consist of qualified opportunity zone property ("Eligible Property"). This is tangible property used in a trade or business in the Opportunity Zone and/or an interest in other entities operating a business in an Opportunity Zone.

The 90% test is based on the average of two tests. The first test measures the percentage of Eligible Properties out of the total assets after the first six months of the taxable year, and the second measures the same on the last day of the taxable year.

The first set of proposed regulations offered some flexibility for funds to meet the 90% test by allowing funds to delay the start of their status as Qualified Funds, with the caveat that a fund should not accept capital from investors prior to being qualified, in order to avoid disqualifying the investment from the Opportunity Zone benefits.

The new set of proposed regulations allow greater relief by eliminating investments received in the six months preceding the application of the test, provided that such investments are held by the Qualified Fund in cash, cash equivalent, or short-term debt instruments.

Additionally, the new set of proposed regulations provide guidance as to the "reasonable period of time" in which a Qualified Fund must reinvest the return of capital from investments in Eligible Property (and the proceeds received from the disposition of Eligible Property) to avoid failing the 90% test.

The new proposed regulations provide that such proceeds would be treated as Eligible Property for purposes of the 90% test for a period of 12 months, provided that such proceeds are held in cash, cash equivalent, or short-term debt instruments.

[1] Opportunity Zones are scheduled to lose their qualified status in 2028, and thus, a concern was raised as to dispositions after such time. The first set of proposed regulations dealt with this concern and provided that dispositions made before December 31, 2047, but after the expiration of Opportunity Zone status would still qualify for the fair-market step-up in basis to exclude post-acquisition gain from tax.

[2] No limitation is imposed on the type of entity that can qualify, as long as it is taxed as a corporation or a partnership. This means that a Qualified Fund may be a C-corporation, an S-corporation, a partnership, or an L.L.C., which may be taxed either as a partnership or a corporation.

Substantially All

As mentioned above, a fund may qualify as a Qualified Fund if it either invests in a qualified opportunity zone business ("Qualified Business") or it operates a Qualified Business itself (or any applicable combination thereof).

A Qualified Business is defined as a business in which "substantially all" of the tangible property (owned or leased) is "Qualified Business Property."

Qualified Business Property is tangible property used in a trade or business for which "substantially all" of the use, during "substantially all" of the Qualified Fund's holding period, occurs in the Opportunity Zone. Additional requirements exist with respect to such property, some of which are discussed later.[3]

> ***"The new set of proposed regulations allow greater relief by eliminating investments received in the six months preceding the application of the test."***

The first set of proposed regulations provided for a 70% threshold to determine if an entity operates a Qualified Business. However, that threshold was only available for this determination and did not apply anywhere else the term "substantially all" appears. The second set of proposed regulations provides that the 70% threshold will apply wherever the term "substantially all" appears in a "use" sense but that a 90% threshold will apply wherever the term is used in a "holding period" sense.

Tangible property will qualify as Qualified Business Property if, during at least 90% of the Qualified Fund's holding period, at least 70% of the use of the property is in an Opportunity Zone.

For an investment in another Qualified Business to meet the requirements, the entity in which the fund purchases an equity interest (other than an interest as a creditor) must operate a Qualified Business not only at the time the interest is purchased but also during "substantially all" of the Qualified Fund's holding period, namely at least 90% of the time the Qualified Fund holds the interest.

Original Use in the Opportunity Zone Commences with the Qualified Fund

The Code requires that the "original use" of a Qualified Business Property in the Opportunity Zone commence with the Qualified Fund. Alternatively, a Qualified Business Property may be substantially improved by the Qualified Fund. The Code defined what would constitute a substantial improvement of a tangible property but did not address the original use test. The first set of proposed regulations reserved on the matter.

The proposed regulations provide that the original use commences on the date when a property is first placed in service in the Qualified Opportunity Zone in a manner that would allow depreciation or amortization by the property's owner. Thus, used tangible property can satisfy the original use test if that property has not previously been used in the Opportunity Zone in a manner that would have allowed it to be depreciated or amortized by any taxpayer.

Vacant buildings and other used tangible property (used in a manner that previously allowed it to be depreciated or amortized) may still qualify if the property has not

[3] These include, but are not limited, to (i) the requirement that the tangible property be acquired after December 31, 2017, (ii) the requirement that such acquisition be from an unrelated person, and (iii) the requirement that the original use of the property in the Opportunity Zone commences with the Qualified Fund or Qualified Business, or that the fund or business substantially improves the property.

been utilized, or has been abandoned, for some time. The proposed regulations suggest that usage history be disregarded after a period of five years since the property was used in business.

Prior guidance on the application of the Opportunity Zone rules to real property provided that the improvement requirement does not extend to the land on which a building is located.[4] In line with this guidance, the second set of proposed regulations provide that the requirement that the "original use" of property in a Qualified Opportunity Zone commence with a Qualified Fund (or a Qualified Business) is inapplicable to land, whether the land is improved or unimproved. To be a Qualified Business Property, land must be used in a trade or business within the meaning of Code §162. Thus, land owned for investment would not qualify as Eligible Property.

Leased Property

The original use test is not applicable to leased tangible property. Neither is the substantial improvement requirement nor the requirement that the property be leased from an unrelated person. However, to avoid abuse, the proposed regulations include certain requirements:

- The lease must be fair market value.
- No prepayment between related parties is allowed for lease terms in excess of 12 months.
- Personal property that is leased from a related lessor may qualify as Eligible Property only if within 30 months (or by the end of the lease term, if shorter) the lessee acquires tangible property that has a value greater than the value of the leased personal property.
- In the case of real property (other than land), leased property would not qualify as Eligible Property if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased for less than fair market value (at the time of the purchase) or for the purchase price to be reduced by rent payments.

RULES RELATING TO INVESTORS IN QUALIFIED FUNDS

A Timely Investment in a Qualified Fund

Deferred gain must be reinvested in a Qualified Fund "during the 180-day period beginning on the date of such sale or exchange." The proposed regulations clarify that a qualifying investment may be made directly in a Qualified Fund or by purchasing an interest in such a fund from another investor.

With respect to the 180-day period, the first set of proposed regulations clarified that taxpayers have 180 days from the day on which the gain would be recognized for Federal income tax purposes but for the Qualified Opportunity Zone election. Further guidance was necessary to advise taxpayers as to the proper date.

[4] Rev. Rul. 2018-29 published concurrently with the first set of proposed regulations.

In the case of capital gains from the sale of property used in a trade or business ("Code §1231 Gain"), the first set of proposed regulations clarified that only Code §1231 Gains in excess of the "Code §1231 Losses" will be treated as capital gain that is eligible for the Opportunity Zone tax deferral election. Consistent with this guidance, the second set of proposed regulations provides that, because the eligible amount of Code §1231 Gain is determined only as of the last day of the taxable year, the 180-day period for reinvesting this capital gain in a Qualified Fund in a manner qualifying for the deferral begins on December 31 of the year of disposition (*i.e.*, the last day of the taxable year), even when Code §1231 Losses are remote.

Similarly, when capital gain is realized by a partnership, the 180-day period ordinarily begins on the last day of the partnership's taxable year and not on the day of the disposition. Partners who wish to reinvest their allocable share of such gains within 180 days from the disposition may do so only if the partnership does not intend to elect to defer the gain and subject to an appropriate election to begin the 180-day period at such time. In the absence of the election, an investment in a Qualified Fund made within 180 days of the disposition date may not qualify for the Opportunity Zone tax benefits if the reinvestment occurs on or before December 31 of the year (*i.e.*, the last day of the taxable year).

"Tangible property will qualify as Qualified Business Property if, during at least 90% of the Qualified Fund's holding period, at least 70% of the use of the property is in an Opportunity Zone."

Eligible Investment Made by Contributing Property Other than Cash

Taxpayers who wish to enjoy the Opportunity Zone election must purchase an equity interest in a Qualified Fund. This purchase may be made for cash received in the disposition of the appreciated property or by contributing other property. The transfer of another property to the Qualified Fund may be a tax-free transaction under any of the nonrecognition provisions (*e.g.*, Code §351 or Code §721) or taxable (if any one of the requirements for a nonrecognition is not applicable). The proposed regulations provide rules regarding the amount treated as invested in the Qualified Fund in a nonrecognition transaction because a taxpayer utilizing a nonrecognition provision generally takes a carryover basis in the interest acquired in return for the transferred property.

The proposed regulations provide that the amount of the investment will be the lesser of (i) the adjusted basis in the transferred property or (ii) the fair market value of the interest in the Qualified Fund received. The proposed regulations further provide that the rules apply to each item of property contributed separately.

This can create a mixed-funds investment situation when the fair market value of the transferred property is higher than the basis in the property and when the investment exceeds the deferred gain. In line with the rule relating to mixed-funds investment, which provides that cash amounts in excess of the deferred gain are treated as a separate investment not eligible for the Opportunity Zone tax benefits, the proposed regulations provide that the total amount of eligible investment made for contributions of non-cash property is limited to the amount of deferred gain and that any excess in fair market value of the Qualified Fund interest received over the adjusted basis of the property contributed will likewise be treated as an ineligible investment.

The proposed regulations provide that the taxpayer's basis in the ineligible investment portion would be the excess (if any) of the basis in the total investment in the Qualified Fund received in return for the property contributed (determined without regard to the Opportunity Zone election) over the basis allocated to the eligible portion of the investment (without regard to the Opportunity Zone election). The basis in the eligible portion may later be increased by the step-up provision available after five, seven, and ten years.

To illustrate, assume a taxpayer has $60 of capital gains eligible for the deferral; the taxpayer decides to invest in a Qualified Fund using another property with a fair market value of $100 and an adjusted basis of $80. As a result, the taxpayer would be treated as having two separate investments in the Qualified Fund:

- An eligible investment of $60 (*i.e.*, the lesser of the fair market value of the interest received ($100) and the adjusted basis of the property contributed ($80) but limited to the deferred gain ($60))
- An ineligible investment of $40 (*i.e.*, the balance of the fair market value of the interest received ($100) over the eligible investment ($60))

The basis of the ineligible investment would be $20.

Investment in a Qualified Fund Formed as a Partnership

The proposed regulations provide for special rules applicable to partnerships.

A transfer of cash or property to a partnership that is characterized as something other than an investment (*e.g.*, a disguised sale rather than a contribution) would not be an eligible investment for purposes of the Opportunity Zone election.

To the extent that the contribution is not disregarded, the amount of the eligible investment is determined in the same manner as provided above, however net of any liabilities. That is, the eligible investment would be the lesser of (i) the net basis in the property contributed (*i.e.*, the adjusted basis over the debt to which the property is subject, but not below zero) or (ii) the net value of the property contributed (*i.e.*, the fair market value over the debt to which the property is subject, but not below zero). The amount of the ineligible investment would equal the excess (if any) of the net value of the contributed property over the eligible investment.

The basis in the eligible portion of an investment would equal the net basis in the contributed property, and the basis in the ineligible portion would be the excess (if any) of the net basis over the basis in the eligible portion of the investment. Both bases are then increased by any debt allocated to the partners and any income allocated to them pursuant to partnership taxation rules. The basis in the eligible portion is further increased by the step-up provision of the Opportunity Zone election available after five, seven, and ten years.

To illustrate, assume a contribution of a property worth $130 subject to a $30 debt and having an adjusted basis of $20. The net basis in $0 (the adjusted basis over the debt, not below zero) and the net value is $100 (fair market value over debt). As a result, the eligible investment would be $0, and the entire investment would be ineligible. The basis of the ineligible investment would be $0 increased by the partner's share of the partnership liability.

Holding Periods

The proposed regulations provide that the holding period, as measured for purposes of the Opportunity Zone rules, is linked to the holding of the qualifying investment. Therefore, if a taxpayer transfers a property in an Opportunity Zone to a Qualified

Fund in return for interest in the Qualified Fund, the holding period requirements that must be met to qualify for each of the relevant tax benefits (five, seven, or ten years) are measured by reference to the receipt of the interests in the Qualified Fund and not to any prior holding period. Likewise, if a taxpayer disposes of an interest in a Qualified Fund and within the 180-day period reinvests the deferred gain in a new Qualified Fund, the holding period begins with the reinvestment in the new Qualified Fund.

Exceptions apply. Generally, when a transfer does not trigger an inclusion event (as discussed below) – *e.g.*, for a transfer by death – the holding period of the transferor would continue.

Deferred Gain Recognition

As mentioned earlier, the deferred gain will be recognized at the earlier of (i) disposition of the investment in the Qualified Fund or (ii) December 31, 2026. The proposed regulations provide a general rule that, unless an exception applies, an inclusion event occurs any time a taxpayer "cashes out" on the rolled-over investment (*i.e.*, when (i) a transfer reduces, for Federal tax purposes, the taxpayer's equity in the qualifying investment in the Qualified Fund or (ii) the taxpayer receives property in a distribution from the Qualified Fund). For this purpose, "property" does not include stock or rights to acquire stock in a Qualified Fund (formed as a corporation). More specifically, the proposed regulations provide a nonexclusive laundry list of transactions that will trigger deferred gain recognition, some of which are mentioned below:

- A taxable disposition of all or part of the investment in the Qualified Fund
- A taxable disposition of an interest in an S-corporation that is the direct investor in a Qualified Fund if, immediately after the disposition, the taxpayer's interest in the S-corporation has changed by more than 25% compared to the ownership at the time that the deferral election was made (Note that the deferred gain will be recognized in whole and not just the portion of the gain relating to the disposed portion of interest.)[5]
- A transfer by a partner of an interest in a partnership that is the direct or indirect owner of interests in a Qualified Fund except if such transfer is tax free contribution into a partnership under Code §721 or a continuation of a partnership through merger under Code §708 which will not result in a reduction in the amount of the deferred gain
- A transfer by gift of interest in a Qualified Fund except for a gratuitous transfer to a trust treated as a grantor trust to the donor

[5] In such circumstances, the proposed regulations view the greater-than-25% change in ownership of the S-corporation as a disposition by the S-corporation of the investment in the Qualified Fund, and the S-corporation will have an inclusion event with respect to the deferred gain. Thereafter, the remaining tax benefits offered by the Opportunity Zone provision (*i.e.*, the partial step-up after five or seven years and the ten-year post-acquisition gain exclusion) will not be available for this investment, which is not in actuality disposed of by the S-corporation.

- A change in the status of a grantor trust causing a change in the owner of the trust property for Federal income tax purposes except for a change by reason of the grantor's death
- A distribution to a partner, by a Qualified Fund formed as a partnership, of property that has a value in excess of the partner's basis in the partnership fund[6]
- A distribution to a partner, by a direct or indirect partnership investor in a Qualified Fund formed as a partnership, of property that has a value in excess of the partner's basis in the partnership
- A distribution of property or a redemption by a Qualified Fund formed as a C-corporation (under Code §301) or an S-corporation (under Code §1368) that is treated as a sale or exchange of property for U.S. tax purposes
- A taxable liquidation of a Qualified Fund (formed as a corporation)
- Nonrecognition corporate transactions involving interests in Qualified Funds formed as corporations where the shareholder has effectively cashed out of the Qualified Fund investment

The proposed regulations describe the methods by which the amount of the recognized deferred gain is calculated.

The Effect on Investors of Disposition of Eligible Property by a Pass-Thru Qualified Fund

When a Qualified Fund taxed as a partnership or an S-corporation disposes of Eligible Property, the disposition may create taxable gain to the partners and shareholders. While commenters were concerned with the gain recognition under such circumstances, the I.R.S. addressed this in the preamble to the proposed regulations and determined that it lacked the authority to exclude such income or gain from recognition. However, because the tax benefits under this provision are tied to the length of the investor's stake in a Qualified Fund and not to the specific portfolio investment, the disposition would not trigger an inclusion of an investor's deferred gain and would likewise not affect an investor's holding period for purposes of the five-year, seven-year, and ten-year tax benefits.

However, for investors holding interests in Qualified Funds formed as partnerships or S-corporations for longer than ten years (after all deferred gain was recognized), the proposed regulations offer an election to exclude gain on the disposition of Eligible Property (reported on Schedule K-1) from gross income. For basis purposes, the exclusion from gross income will nevertheless be treated as distributive share, which increases the taxpayer's basis in the interest in the Qualified Fund.

[6] Note that while the basis of a qualifying investment begins with zero, debt allocated to this investment will increase the basis and a distribution is excess of this adjusted basis will trigger deferred gain recognition to that extant. In a mixed-funds investment, the tracking for purposes of the Opportunity Zone rules will be different than tracking of the investment for purposes of partnership taxation rules, which will treat the mixed-funds investment as one and thus may not tax a distribution under Subchapter K as a distribution that is taxed as an inclusion event of the deferred gain.

A similar rule applies to a Qualified Fund that is a real estate investment trust (“R.E.I.T.”). As a result, holders of shares in a Qualified Fund R.E.I.T. may receive specially designated capital gain dividends (limited by the long-term capital gains on sales of Eligible Property) on a tax-free basis, provided that they meet the ten-year requirement and would have been eligible to elect to step up the basis in the stock to fair market value if they were disposing of the stock.

Transfer of a Qualifying Investment by Death

Unlike a transfer by gift, the transfer of an interest in a Qualified Fund by death is not an inclusion event that triggers deferred gain recognition. Here, the recipient will have the obligation to include the deferred gain in gross income come December 31, 2026, or an earlier inclusion event.

Investing Foreign-Source Capital Gains

No limitation applies with respect to the source of the deferred capital gain that is reinvested in a Qualified Fund. However, as noted in previous articles, due to foreign tax being paid in the source country, and the availability of a foreign tax credit to offset the U.S. tax imposed on the foreign-source gain, it may be inefficient to defer gain recognition in the U.S.

Notwithstanding the aforementioned, if the goal is to reap the ten-year tax benefit (*i.e.*, the complete exclusion of the post-acquisition gain), a deferral may be worth considering. For example, assume foreign tax is imposed at 25% and foreign capital gain is equal to $1,000,000. If the taxpayer is a U.S. individual, the U.S. long-term capital gains tax rate is 20%. As a result, the tax due in the U.S. for the year of the sale would be $200,000. But, if $250,000 were paid in foreign taxes, the individual would not necessarily owe additional U.S. tax for this sale if foreign tax credits can be utilized, and deferral would not appear to be tax efficient. However, if the individual is considering an investment in a Qualified Fund that seems attractive regardless of the tax incentive, and if we assume the value is expected to appreciate substantially over a ten-year period, the deferral should be considered. Assume the new property triples in value:

> ***“An inclusion event occurs any time a taxpayer ‘cashes out’ on the rolled-over investment.”***

- Without the Opportunity Zone election, in 2019, the individual invests the net proceeds ($750,000); when the value triples to $2,225,000 in year ten and the individual disposes of the investment, the U.S. tax liability is 20% on capital gains of $1,500,000, *i.e.*, $300,000.
- The total tax is $250,000 in foreign taxes on the first transaction (no U.S. tax if foreign tax credits are available) plus $300,000 on the second transaction, *i.e.*, $550,000.
- With the election, the amount available to invest in a Qualified Fund is $750,000 (unless the taxpayer has other funds or property to invest). In 2026, the individual has a mandatory inclusion of $750,000 ($1,000,000 if additional funds are invested) deferred from 2019. However, if the initial investment was in 2019, in 2026 the taxpayer is eligible for a 15% step up in basis. Thus, the gain included in 2026 is only $637,500 (in the case of a $750,000 investment) or $850,000 (in the case of a $1,000,00 investment), and the tax due is $127,500 or $170,000, respectively. In year ten, when the property is sold for $2,225,000 ($750,000 investment) or $3,000,000 ($1,000,000

investment), there will be no U.S. tax due to the Opportunity Zone election.

- The tax is $250,000 in foreign taxes on the first transaction – with no U.S. tax on the $250,000 gain realized in the year of the sale and with respect to which no deferral election is made if foreign tax credits are available ($750,000 investment) or no U.S. tax without regard to any foreign tax credit, as all gain is deferred ($1,000,000 investment) – plus $127,500 ($750,000 investment) or $170,000 ($1,000,000 investment) in the U.S. on the deferred date of 2026 (or possibly less if excess foreign taxes can be utilized) and $0 on the second transaction. On an investment of $750,000, the total is $377,500 if foreign tax credits offset the tax on the gain in the year of sale that is not deferred. On an investment of $1,000,000, the total tax is $420,000.
- Additionally, there may be circumstances where no foreign tax is imposed on a disposition of capital property but U.S. tax is still imposed, and as a result, the deferral itself would also be an attractive benefit. For example, Israel does not tax the sale of an individual's personal home if certain conditions are met. If the individual is a dual citizen of Israel and the U.S., notwithstanding the Israeli tax exemption, U.S. tax would apply to the disposition, and an Opportunity Zone election should be considered.

CONCLUSION

The clock is ticking for investors that are still observing the Opportunity Zones from the sidelines. While those who wish to utilize the fullest tax benefits should hurry, investment opportunities should be carefully scrutinized, particularly because Opportunity Zones are often unfamiliar areas for investors. The analysis should ensure that the tax benefits associated with the election are a sweetener but that the transaction is sound without those benefits. The I.R.S. is working hard to assist the industry so that capital injections in Opportunity Zones can become a reality.

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