Second Set of Qualified Opportunity Zone Proposed Regulations Provide Clarity to Potential Investors

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As discussed here in November (Why 2019 Will be the Year of Opportunity (Zones)), the Tax Cuts and Jobs Act created a tax-advantaged incentive program for investing in designated "qualified opportunity zones" throughout the country, including many locations in Arkansas. The opportunity zone program allows investors to temporarily defer tax on capital gains if the gains are reinvested in "qualified opportunity funds." Tax on the reinvested gains will be deferred until December 31, 2026 (or earlier if the QOF investment is sold or exchanged before then), and the program builds in additional breaks for investments held for 5, 7 and 10 years.

A Qualified Opportunity Fund, or QOF, is an investment entity organized as a corporation or a partnership that holds at least 90% of its assets in QOZ Property. QOZ Property includes not only real estate located in an opportunity zone, but also stock or partnership interests of a QOZ business, and other tangible property used in a trade or business, if the property was acquired by a QOZ business by purchase after December 31, 2017, the original use of the property in the QOZ commences with the QOF or the QOF substantially improves the property, and during "substantially all" of the QOF's holding period for the property, "substantially all" of the use of the property was in a QOZ.

The IRS issued proposed regulations in October 2018 to address some of the many questions investors and potential QOF sponsors have about the details of investing in QOFs. However, those proposed regulations left many issues unanswered. On April 17, 2019, the IRS issued a second set of proposed regulations (IRS Prop. reg-120186-18) which address many of those lingering questions, giving potential QOF investors more assurance and direction with respect to important aspects of QOF businesses. following is a non-exhaustive list of a few issues addressed by the new proposed regulations:

1. Timing for 180-Day Rule. Generally, an investor has 180 days to reinvest "capital gains" in a QOF and defer the tax on those gains . The proposed regulations clarify that the 180 day period does not begin until the last day of the taxpayer-investor's taxable year in which such gain is recognized. The regulations also clarify that "capital gains" means a taxpayer's "net section 1231 gains" for the year. Thus, an investor that recognized net section 1231 gain in 2018 has until June 29th to invest the amount of the gain in a QOF.

2. "Substantially All": The regulations further define the two uses of the phrase "substantially all" in the QOZ statutes regarding the use of tangible property owned by a QOZ business or QOF. Regarding the requirement that tangible property be used by a QOZ business for "substantially all" of the QOZ business's holding period for the property, "substantially all" means 90% of such holding period. Regarding the "use"

requirement, the proposed regulations state that the substantially all requirement regarding "use" is satisfied if at least 70% of the use of such tangible property is in a qualified opportunity zone.

3. Methods of Acquiring QOF Interest. The proposed regulations clarify that an investor may defer capital gain by investing cash or property in a QOF, or by purchasing an interest in a QOF directly from another investor.

4. Active Conduct of a Trade or Business. At least 50 percent of the gross income of a QOZ business must be derived from the active conduct of a trade or business within the opportunity zone. The proposed regulations provide that the ownership and operation (including leasing) of real property is treated as the active conduct of a trade or business for purposes of the opportunity zone rules. However, a mere triple-net-lease, without any other associated business activity, is not considered the active conduct of a trade or business.

5. Inclusion of Deferred Gains. In general, tax on capital gains reinvested in a QOF is deferred until the earlier of (i) the date on which such investment is sold or exchanged and (ii) December 31, 2026. The Proposed Regulations further define what “sold or exchanged” means by providing a list of “inclusion events.” An inclusion event generally means a taxpayer’s transfer of a QOF investment in a transaction that (1) reduces the taxpayer’s equity interest in the QOF or (2) involves the receipt of money or other property in a transaction that is treated as a distribution for tax purposes. Interestingly, a transfer of an interest in a QOF by gift generally is an inclusion event, but a transfer of a QOF interest upon death is generally not an inclusion event.

6. Disguised Sale Partnership Distributions Disallowed. The proposed regulations provide that, in a QOF taxed as a partnership, the investor’s investment will be reduced to the extent any distributions to an investor financed with partnership debt or otherwise would be treated as a disguised sale under existing partnership tax rules.

7. Leased Tangible Property. Generally, QOZ property purchased by a QOF or QOZ business must be either originally used or substantially improved by a QOZ business. The proposed regulations clarify, however, that the rules original use rules do not apply to tangible property leased by a QOZ business. However, the lease must be entered into after December 31, 2017, and the lease must provide for a market rate of rent. If the property is leased from a related party, the lessee may not make prepayments in connection with the lease for a period of use exceeding 12 months.

Although these latest proposed regulations provide potential QOF investors and fund sponsors much needed clarity, they are still subject to change and further clarification until finalized. The proposed regulations do provide, however, that taxpayers may generally rely on the rules for periods prior to finalizations if they apply the proposed rules consistently and in their entirety.