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Legal Update

Second Time Around: The IRS Issues More Qualified Opportunity Fund Regulations

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Maybe because it's spring, but it seems to us that love and the US Internal Revenue Service ("IRS") guidance on qualified opportunity funds (individually, a "QOF") have a lot more in common than we would have suspected. Poets tell us that love is lovelier the second time around.[1] And, it turns out, so is QOF guidance. On April 17, 2019, the IRS released a second set of proposed regulations addressing the issues faced by taxpayers in structuring QOF transactions.[2] These regulations supplement and, in certain cases, override the proposed regulations issued by the IRS in October 2018.[3] The IRS is allowing taxpayers to rely on the April 2019 proposed regulations in 2018 and after, provided that they adopt all of the regulations and not just selected portions. This Legal Update explores the new proposed regulations and their implications for structuring QOF transactions.

Brief Background

Broadly speaking, the QOF rules operate as follows. An eligible taxpayer invests an amount equal to the capital gain that the taxpayer desires to defer in a QOF within 180 days from the date of the actual or deemed recognition of the capital gain. The QOF must be a partnership or corporation. This rule prevents the taxpayers who recognized the gains to be deferred from making qualified opportunity zone investments directly. The QOF then must make an investment in qualified opportunity zone property. Qualified opportunity zone property may be qualified opportunity zone stock, qualified opportunity zone partnership interests or qualified opportunity business property.[4]

Mechanically, the statute operates on two separate tracks. One track governs the deferred gain and the second track governs the investment in the QOF. The taxpayer is initially deemed to have a zero tax basis in the QOF, despite having invested cash. If it holds the investment for at least five years, it increases its basis in the QOF by 10% of the amount of the originally deferred gain (and the tax on 10% of the deferred gain is essentially forgiven). After it has held the property for at least seven years, it increases its basis in the QOF by another 5% of the originally deferred gain (and the tax on 5% of the deferred gain is essentially forgiven). In 2026 (or earlier if the investment is disposed of or there is an another inclusion event), the lesser of all deferred gain and the excess of the fair market value of the QOF investment over the taxpayer's basis is then recognized and subject to tax.[5]

If the investor holds its QOF investment for at least 10 years, the taxpayer may elect, on the date of disposition, to increase its basis to the fair market value of the investment, thus providing a tax-free return on gains recognized with respect to the QOF investment. In all cases, the income earned by the QOF during its life is taxed to the investor (or the QOF itself if it is a corporation) under the regular tax rules, that is, the QOF rules do not impact current income from the QOF investment.

Gains Eligible for Deferral

The April 2019 regulations provide two rules with respect to gains taxable under Code § 1231. First, such gains are eligible for deferral only to the extent that they exceed losses from dispositions of section 1231 property.[6] Second, such net gains are deemed to be realized on the last day of the taxable year.

Importantly, if a taxpayer recognizes gain on the transfer of property (whether by contribution or sale) to a QOF in exchange for an interest in the QOF, such gain is not eligible for deferral under the QOF regime.[7]

Contributions

The April 2019 regulations provide special rules for determining the amount contributed to a QOF. Under these special rules, if the contribution by the investor to the QOF is a carry-over basis transaction, the amount contributed is equal to the lesser of the basis of the property transferred and the fair market value of the QOF interest received in the transaction.[8] Contributions in excess of the amount permitted to transferred to a QOF will create a mixed-use fund.[9] Taxable dispositions of property to a QOF in exchange for an interest in the QOF are specifically treated as qualifying transfers to the QOF.[10] Transfers to a QOF partnership that are treated as disguised sales, however, are not treated as a QOF investment.[11] Certain debt-financed distributions by QOF partnerships can result in disguised sales for this purpose.

The April 2019 regulations contain a special rule that treats the acquisition of an outstanding eligible interest in a QOF as a qualifying contribution to the QOF.[12] This rule should allow an investor to purchase a QOF interest from a third party and be considered to have made a qualifying contribution to the QOF. It is unclear why the IRS proposed to treat acquisitions of QOF interests from third parties as qualifying acquisitions of QOF interest while at the same time treating disguised sales of partnership interests and stock as not be qualifying contributions.

Basis and Basis Step-Up Guidance

As noted above, a taxpayer's initial basis in a QOF is zero.[13] In the case of QOF partnerships, however, the investor does receive outside basis for its share of partnership debt.[14] Basis is stepped up by 10% of the deferred gain after five years and by another 5% after seven years.[15] An investor does not tack on any holding period prior to the contribution to the QOF in determining whether the holding period requirement is met. The April 2019 proposed regulations clarify that such basis increases will result in the allowance of suspended losses. The April 2019 proposed regulations also clarify that if the QOF is a partnership, the partnership will take a carry-over basis in property transferred to the QOF even though the investor's basis in the QOF partnership is zero.

Basis adjustments resulting from the recognition of the deferred gain in 2026 are made immediately after the income is recognized. Basis adjustments resulting from inclusion events, including redemptions or other reductions in direct tax ownership, however, are made immediately prior to the inclusion event. Basis adjustments with respect to dispositions of QOF investments held at least 10 years are made immediately prior to the disposition. Any such basis adjustments are pushed down to the assets of the QOFB that is a partnership.[16]

The QOF Asset Test

The QOF statue itself provides that a partnership or corporation will be treated as a QOF only if at least 90% of its assets are invested in qualified opportunity zone property on each testing date.[17] The April 2019 proposed regulations provide a relief rule under which cash capital contributed to a QOF will not be counted against satisfaction of the 90% asset test if the capital was contributed within the 6 months preceding an asset testing date. QOFs can selectively apply this rule from testing period to testing period. In addition, if a QOF fails the asset test during its first year, it will be subject to a penalty but will not be disqualified from being treated as a QOF.[18] The calculation of the amount of the penalty remains uncertain.

The April 2019 regulations provide further relief from the 90% asset test for proceeds from the disposition of QOF investments. Specifically, the regulations provide that disposition proceeds will count towards satisfaction of this test during the 12-month period beginning on the date of such disposition, provided the proceeds are held in cash or debt instruments with a term of less than 18 months.[19] The 12-month period may be extended for any period during which the reinvestment is delayed due to governmental action.

"Substantially All" Requirements

The QOF statute uses the phrase "substantially all" in five places. The statute, however, does not define when this standard will be met in any of these cases. The October 2018 proposed regulations provided that a qualified opportunity zone business (a "QOZB") would meet the requirement that substantially all of its tangible property be owned or leased in the qualified opportunity zone if 70% of the tangible property was used in the QOZB (the "QOZB Asset Test").[20] The April 2019 proposed regulations provide guidance on when the "substantially all" requirement will be met in the other instances in which such requirement appears:

REQUIREMENT	STANDARD
Substantially all of the use of tangible property be in a qualified opportunity zone ("QOZ"):[21]	70%
Holding period for tangible property during which the property is used as a QOZB:[22]	90%
Corporation will be treated as a QOZB if during substantially all of the time that the taxpayer held the stock the corporation was engaged in a QOZB:[23]	90%
Partnership will be treated as a QOZB if during substantially all of the time that the taxpayer held the partnership interest, the partnership was engaged in a QOZB:[24]	90%

The preamble notes that the combination of these rules allows a transaction to qualify as a QOF even if as little as 40% of the tangible property in the transaction is used in a QOZ. Specifically, a QOF may hold 10% of its assets in non-qualifying property. A QOZB need hold only 70% of its tangible assets in qualified opportunity zone property. Qualified opportunity zone property must be held for use in the QOF for 70% of use. In addition, a QOZB need hold the property for 90% of its holding period in its QOZB. This yields 40% of QOZB use: 90% x 70% x 70% x 90%.

The Original Use and Substantial Improvement Requirement

A business will not be treated as a QOZB unless the "original use" of its tangible property commences in the QOZ or the property is "substantially improved" by the QOZB.[25] The April 2019 proposed regulations provide guidance on when original use is considered to commence. Specifically, property will satisfy the original use requirement only if it is first placed in service in the QOZ.[26] Used property, that is, property for which another taxpayer previously claimed depreciation deductions for use inside of the QOZ, cannot meet the original use requirement. Conversely, used property that has not been used inside a QOZ can meet the original use test when used by a QOF. The use of a building or other tangible property that has been vacant (unused) for at least five (5) years in a QOZB, however, will be considered to meet the original use requirement. Also importantly, the April 2019 regulations explicitly state that leasehold improvements made by a lessee will be considered to meet the original use requirement. Land itself is not subject to the original use requirement.[27]

The substantial improvement test requires that during any 30-month period, the cost of improvements equal the adjusted basis of the property at the beginning of the 30-month period.[28] The proposed regulations state the substantial improvement test is conducted on an asset-by-asset approach. The application of this approach to operating businesses is likely to be challenging. The preamble to the regulations states, however, that the IRS would consider input as to when assets should be grouped for purposes of this test.

The Trade or Business Requirement

The statute only specifies that the activities must constitute a trade or business to be a QOZB.[29] The April 2019 proposed regulations make clear that holding of land for investment will not constitute a valid QOZB. The proposed regulations also state that the use of land for the production of an agricultural crop will not be treated as a QOZB. Most likely, this rule is intended to curb the benefits of the QOF rules to cannabis businesses.

Rules for Leased Property

The issue as to the treatment of leased property comes up in two contexts. First, there is an issue as to whether leased property counts towards the requirement that 90% of the assets of a QOF be invested in qualified opportunity zone property (the "90% QOF Asset Test").[30] Second, there is an issue as to how leases are accounted for with respect to the QOZB Asset Test (i.e., the requirement that substantially all of the assets of a QOZB be qualified opportunity zone property).[31] The April 2019 proposed regulations provide several rules for determining when and how leased property will be taken into account under these provisions.

First, leased property will count towards satisfaction of the 90% QOF Asset Test and QOZB Asset Test only if the lease is entered into after December 31, 2017. Second, substantially all of the use of the leased tangible property, that is, at least 70% of the use, must be in a QOZ. In other words, leased property is included in both the numerator and denominator of these fractions. Thus, start-up businesses that lease office space in QOZs are more likely to be able to satisfy the 90% QOF Asset Test and the QZOB Asset Test.

In contrast to the rule for purchased property, however, the original use of the leased property need not originate in the QOZ nor must the leased property satisfy the substantial improvement test, but the lease must be entered into after December 31, 2017.[32] Although the proposed regulations do not prohibit leases with related parties, related party lease prepayments must be limited to 12 months or less. If the QOZB has a related party lease over personal property, such lease will not be qualified opportunity zone property unless the lessee also becomes the owner of tangible property that has a value that is not less than the value of the leased personal property. The April 2019 proposed regulations do, however, require that a related party lease be a "market rate lease," that is, the lease terms must be on arm's length.[33] The proposed regulations also contain an anti-abuse rule that prevents real property leases from being treated as qualified opportunity zone property if, at the inception of the lease, there was a plan, intent or expectation that the lessee would acquire the property for an amount that is less than the fair market value of the property at the time of any such sale.[34]

The April 2019 proposed regulations contain rules for the valuation of leased tangible property. The leased property must be valued annually under one of two methods.[35] The chosen method applies to all leased property held in that year. The taxpayer may use the value shown on an applicable financial statement, provided that statement is prepared in accordance with US generally accepted accounting principles ("GAAP"). Alternatively, a taxpayer may value leased property by discounting the rent payments using the applicable federal rate. An election to use the discounted rent value must be made at the time of the lease inception and is binding once made.

The Gross Income Requirement

A QOZB must derive at least 50% of its gross income from the active conduct of trade or business within a QOZ (the "50% Gross Income Test").[36] The April 2019 regulations provide three safe harbors with respect to this requirement. First, a QOZB will meet the 50% Gross Income Test if at least 50% of the services provided by employees and independent contractors are performed in the QOZ. The preamble notes that service-intensive businesses can use this safe harbor even when their sales occur outside of the QOZ. Second, a business will meet the 50% Gross Income Test if at least 50% of the amount paid for employee and independent contractor services are paid for services performed within the QOZ. Last, the 50% Gross Income Test will be considered satisfied if: (i) tangible property of the business within the QOZ and (ii) the management or operations with the QOZ are necessary to generate 50% of the gross income of the business. The preamble uses, as an example for this third test, a landscaping concern that is run from and equipment is stored within a QOZ, but whose services are performed outside the QOZ. A business that fails the safe harbors may still establish that it satisfies the 50% Gross Income Test based upon relevant facts and circumstances.

If a business uses intangibles, a substantial portion of such intangibles must be used in the active conduct of the QOZB. The April 2019 regulations define a "substantial portion" as at least 40%.

The April 2019 regulations define a trade or business with reference to activities that give rise to trade or business deductions under

Code § 162. In addition, the April 2019 regulations contain a special rule that treats all leases of real property as trade or business activities but caution that this rule should be extended beyond the QOF rules.

The April 2019 regulations provide additional clarity for businesses that hold real property straddling both a QOZ and a non-QOZ. Specifically, when it is necessary to determine whether a QOZ is the location of services, tangible property or business functions (such as, for example, for purposes of the 50% Gross Income Test), all of the business's property will be deemed to be located within a QOZ if two requirements are met. First, the amount of real property based on square footage located within a QOZ must be substantial as compared to the amount of real property based on square footage located outside of the QOZ. Second, the real property outside of the QOZ must be contiguous to all or part of the real property located inside the QOZ.

The Working Capital Rule

The October 2018 proposed regulations provided a safe harbor pursuant to which working capital would be considered to count towards satisfaction of the QOF Asset Test, the QOZB Asset Test and not count against the requirement that no more than 5% of assets be held in financial instruments. Specifically, all amounts held as working capital would be treated as qualified assets if there is a written plan to acquire, construct and/or substantially improve tangible property use in the QOZ within 31 months.[37] The April 2019 regulations expand the safe harbor in two ways. First, it is extended to include working capital accumulated to develop a trade or business. Second, the 31-month rule will not be considered violated if it is extended due to governmental action. In addition, the April 2019 regulations contain an example that makes clear that the 31-month rule is applied from the date of each capital contribution to the QOF or QOZB.

Rules for Multi-Asset QOFs

The April 2019 proposed regulations effectively allow a pass-through QOF to invest in multiple assets. As discussed above, if a taxpayer holds an interest in a QOF for at least ten years, such taxpayer can elect to increase its basis in the interest in the QOF to the fair market value, thus providing a tax-free return on the QOF investment. Prior to this new guidance, however, it was unclear whether a taxpayer could receive a comparable tax benefit if a pass-through QOF sells its QOZ property after 10 years. This uncertainly led many pass-through QOFs to be set up as a single asset fund to permit investors in such a QOF to exit their investments in an underlying QOZ property by way of selling their interests in the QOF.

The April 2019 proposed regulations clarify that if a pass-through QOF sells a QOZ property, each qualifying investor in the QOF can elect to exclude from gross income its share of the capital gain on the sale (to the extent such gain is separately stated in the applicable Schedule K-1), if the sale occurs after the investor's 10-year holding period. If a taxpayer makes this election, the excluded amount of capital gains will increase the taxpayer's outside basis in the QOF. Similarly, the April 2019 proposed regulations authorize a QOF REIT to designate its long-term gains on sales of QOZ property as "special capital gain dividends" that are not taxable to those shareholders holding the REIT shares for at least 10 years. It is worth noting that this special election does not apply with respect to the sale of any non-QOZ property held by a QOF. Therefore, there still may be some marginal tax benefits for a single asset QOF, if such QOF owns a meaningful amount of non-QOZ property and investors can exit their investments by way of selling their interests in the QOF.

Events That Cause Inclusion of Deferred Gain

The 2019 proposed regulations provide guidance on events that will cause an investor to recognize all or a portion of their deferred gain prior to December 31, 2026 ("inclusion events").[38] Subject to certain exceptions, an inclusion event generally occurs where a taxpayer transfers its interest in a QOF in a way that reduces the taxpayer's equity interest in the QOF. The stated aim of these rules is to prevent taxpayers from "cashing out" of their investment without recognizing as income any amount of their deferred gain. The regulations provide a nonexclusive list of inclusion events, including taxable dispositions of direct or indirect QOF interests, transfers by gift of QOF investments (e.g., charitable contributions), certain distributions in excess of basis from QOF partnerships and QOF corporations and certain redemptions of stock and liquidating distributions from QOF corporations, as well certain transactions that are otherwise treated as tax-deferred transactions under the Code. Neither transfers by reason of death nor contributions to grantor trusts generally are considered inclusion events under the proposed regulations.[39]

The amount of deferred gain recognized upon an inclusion event generally is the lesser of (a) the fair market value of the portion of the QOF interests sold or (b) a proportionate amount of the remaining deferred gain, over the taxpayer's basis for the interest sold. A special rule for partnerships requires a different calculation based on the percentage of the QOF interest disposed of.

Carried Interest Not Entitled to QOZ Benefits

The treatment of carried interest under the QOF rules has been one key area of uncertainty for sponsors of QOFs. The proposed regulations clarify that the share of gain attributable to the service component of an interest in a QOF partnership is not eligible for the benefits of the QOZ program, even though all of the partnership's assets might consist of qualifying QOZ property.[40] Thus, if a service provider makes a capital investment consisting of eligible gain and also receives a profits interest in a QOF partnership for the performance of services, the investment is effectively bifurcated, with only the capital portion of the investment being entitled to QOZ benefits. Special rules apply in calculating the allocation of QOZ benefits between the capital interest and the profits interest, with the percentage attributable to the profits interest being treated as a non-qualifying investment to the extent of the highest percentage interest in residual profits the service provider would receive with respect to that interest.

Dispositions of QOZB Investments by a QOF

The April 2019 regulations provide special rules for the dispositions of QOZB investments by QOFs. Under the proposed regulations, gain is recognized with respect to such dispositions. Deferred gain of an investor in the QOF is not triggered however, provided that the disposition proceeds are reinvested within 12 months.

Consolidated Return Guidance

The April 2019 proposed regulations provide that a QOF organized as a corporation cannot be a member of an affiliated group of corporations filing a consolidated federal income tax return, but can be the common parent of an affiliated group. In addition, if a member of an affiliated group filing a consolidated return has gain that it desires to be deferred through a QOF investment, that member must make the investment into the QOF. The April 2019 proposed regulations also contain technical rules of application for members of affiliated groups filing consolidated returns that make QOF investments. These rules include tiering up adjustments for basis increases in QOFs and attribute reduction rules for stock dispositions.

Broad Anti-Abuse Rule

Using the broad authority granted to the IRS in the statute itself, the April 2019 proposed regulations provide that if a significant purpose of a transaction is to achieve results that are inconsistent with the purposes of the QOZ program, the IRS can recast a transaction (or series of transactions) to achieve appropriate tax results. All facts and circumstances will be considered when determining whether a tax result is inconsistent with the QOZ rules. Specific areas of concern highlighted throughout the preamble include speculative "land banking" by QOFs or QOZBs, inappropriate use of the special election by partnerships with regard to asset sales and the proposed safe harbors for the 50% Gross Income Test. The IRS signaled that additional anti-abuse rules may be forthcoming.

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Endnotes

[1] Our apologies to Sammy Cahn and Jimmy Van Heusen for mauling the lyrics to their fine song, "The Second Time Around" (1960).

[2] REG-120186-18 (April 2019).

[3] REG-115420-18 (October 2018). For our coverage of the October 2018 proposed regulations, see https://www.mayerbrown.com/en/perspectives-events/publications/2018/10/just-released-irs-qualified-opportunity-fund-guida

[4] The operation of the QOF rules are explained in an earlier Legal Update: https://www.mayerbrown.com/en/perspectives-events/publications/2018/08/gain-deferral-using-qualified-opportunity-zone-inv

[5] Prop. Treas. Reg. § 1.1400Z2(b)-1(e)(3).

[6] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(iii).

[7] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(vi).

[8] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(i)(B).

[9] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10).

[10] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(i)(C).

[11] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(A)(1).

[12] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(9)(iii).

[13] Code § 1400Z-2(b)(2)(B)(i).

[14] Prop. Treas. Reg. § 1.1400Z2(b)-1(g)(3).

[15] Code § 1400Z-2(b)(2)(B)(iii), (iv).

[16] Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2).

[17] Code § 1400Z-2(d)(1).

[18] Prop. Treas. Reg. § 1.1400Z1(f)-1(a).

[19] Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(4).

[20] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(i).

[21] Section 1400Z-2(d)(2)(D)(i)(III) of the Internal Revenue Code of 1986, as amended (the "Code").

[22] Code § 1400Z-2(d)(2)(D)(i)(III).

[23] Code § 1400Z-2(d)(2)(B)(i)(III).

[24] Code § 1400Z-2(d)(2)(B)(i)(III).

[25] Code § 1400Z-2(d)(2)(D)(i)(II).

[26] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(i)(E)(7).

[27] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(E)(8)(ii)(B).

[28] Code § 1400Z-2(d)(2)(D)(ii).

[29] Code § 1400Z-2(d)(3)(A).

[30] See Code § 1400Z-2(d)(1).

[31] See Code § 1400Z-2(d)(3)(A)(i).

[32] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4).

[33] Prop. Treas. Reg. § 1.1400Z2(d)—1(c)(i)(4)(B)(2).

[34] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(i)(E).

[35] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(i)(B)(8).

[36] Code § 1400Z-2(d)(3)(A)(ii).

[37] Prop. Treas. Reg. § 1.1400Z2(b)-2(d)(1)(iv).

[38] Prop. Treas. Reg. § 1.1400Z2(b)-1(c)(1).

[39] Prop. Treas. Reg. § 1.1400Z2(b)-1(c)(5).

[40] Prop. Treas. Reg. § 1,1400Z2(a)-1(b)(9)(ii).