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Opportunity Zones - The Current State of Play Following Release of the Second Set of Proposed Regulations

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A little known, and often misunderstood, aspect of the Tax Cuts and Jobs Act of 2017 (the "TCJA") is Internal Revenue Code Section 1400Z-1, which permits states to designate certain "low-income" census tracts as "opportunity zones," and Section 1400Z-2, which offers certain Federal tax incentives to taxpayers who invest qualified capital gains into these designated opportunity zones. The opportunity zone program has generated significant national and local interest due to both its (i) ambitious goal of driving economic development in distressed communities, and (ii) generous tax benefits, but until recently many details of the law's application remained unknown.

Although various tax incentives for investments benefiting low-income communities have long been available (ex., Enterprise Zones, LIHTC, etc.), many people believe the flexibility offered by the opportunity zone program is the key to actually driving such investment in sufficient quantities. However, since the opportunity zone program's inception, investors have been slow to commit significant amounts of capital due to the complex and technical nature of qualifying for the tax incentives and the general lack of comprehensive and clear guidance regarding the application of the broad language in the TCJA.

In October 2018, the United States Department of the Treasury ("Treasury") released a first set of proposed regulations, answering many questions as to the new law's application, but leaving significant details unanswered or ambiguous. These initial

proposed regulations gave industry professionals and potential investors guidance on structuring opportunity zone investments in single-asset real estate development projects, but failed to adequately provide for guidance with respect to investments in operating businesses in opportunity zones. The stated public policy objectives surrounding the law's passage centered on facilitating investment and job creation in these communities, but without adequate guidance these objectives went unrealized.

Much has been written about the October 2018 proposed regulations, and this article will not go into length on that subject, but it is important to understand certain basic facts about opportunities zones, their intent and how Treasury has attempted to structure the proposed regulations to address that intent, before breaking down the newly released proposed regulations.

In general, any "taxpayer" (which can include individuals, corporations and partnerships) with qualified capital gains can invest those gains into a qualified opportunity fund (a "QOF") and defer the tax otherwise payable on those gains until December 31, 2026. In addition, if the investment in the QOF is held for at least five (5) years (and satisfies certain other rules regarding the nature of the investment), the investor can receive a 10% step up in basis on those gains. If the investment in the QOF is held for at least seven (7) years and other requirements are met, the investor can receive an additional 5% step up in basis on those gains (for a total step up in basis of 15%). If the investment is held for at least ten (10) years and other requirements are met, any additional gains resulting from the taxpayer's investment into the QOF are tax-free to the investor. These potential tax benefits are substantial and generated significant interest from investors, but too little was known or understood (outside of single asset real estate developments) for investors to commit to tying-up significant capital for the extended period of time necessary to achieve the maximum potential benefits.

In response, Treasury released a second round of proposed regulations regarding opportunity zones in late April 2019. This second round of proposed regulations attempts to resolve a number of previously unanswered questions and specifically address the topics noted below. The remainder of this discussion assumes that the reader already has an understanding of the basic statutory requirements associated with the opportunity zone framework.

1. Qualifying Investments:
   (a) A taxpayer is able to claim the tax incentives based on a contribution of cash or property to a QOF.
   (b) Carried interests and other profits interests granted in exchange for the performance of services cannot qualify for the opportunity zone tax incentives.

2. Original Use and Substantial Improvement:

(a) The substantial improvement requirements do not apply to unimproved land. Unimproved land will meet the original use test if it is actually used in a trade or business and the QOF intends to improve the land (in some material fashion) within thirty (30) months of its direct or indirect acquisition of the subject land.
(b) A building that has been vacant for five (5) or more years can qualify under the original use test.

3. Leased Property
   Leased property can satisfy the qualified opportunity zone business property requirements, so long as (i) the lease was entered into after December 31, 2017, (ii) the lease is on market-rate terms, and (iii) the leased property, during the QOF's direct or indirect ownership thereof, is substantially within a qualified opportunity zone. There are additional, more-stringent requirements if the lease is between related parties. In addition, a lease does not need to satisfy the original use requirements or be substantially improved. The potential impact of this change cannot be understated, particularly with respect to the law's stated goal of job creation in these communities, as many operating businesses lease, rather than own, their work space. This is particularly true with early stage, start-up businesses, precisely the types of businesses the opportunity zone legislation was designed to attract to these communities.

4. Working Capital Flexibility:
   (a) The thirty-one (31) month working capital safe harbor period is tolled during delays created in connection with seeking required approvals from governmental entities.
   (b) If a QOF makes multiple, separate capital calls from investors, the working capital safe harbor period can apply based on each individual contribution date.

5. Income Sourcing for Operating Businesses:
   One of the topics most in need of additional guidance was the application of the 50% gross income test, as it pertains to a qualified opportunity zone business (a "QOZB"). To obtain the tax benefits noted above, a QOF must invest "substantially all" of its assets either directly in qualified opportunity zone property ("QOZP") or indirectly in QOZP through ownership of a QOZB which, in turn, holds the QOZP. The proposed regulations create broad, flexible income sourcing rules with four (4) discrete ways to satisfy the gross income test, with the first two focused on the services performed by a QOZB rather than the QOZB's income. These safe harbor provisions are satisfied: (1) if at least 50% of the QOZB's work hours, whether performed by employees or independent contractors, are performed in an opportunity zone; (2) if at least 50% of the QOZB's payroll and employment expenses are applicable to employees or independent contractors working in an opportunity zone; (3) if at least 50% of a QOZB's income is generated from assets and operations located within an opportunity zone; or (4) under a broad "facts and circumstances" test. As with

the new proposed regulations regarding leased property noted above, we believe these safe harbor provisions will encourage job creation in opportunity zone communities by broadening the methods by which operating businesses can satisfy the gross income test.

6. Debt-funded Distributions:
   A QOF is generally permitted to make distributions with income generated through financing, but subject to two limitations: (i) any distribution in excess of an investor's basis in the QOF (including its share of the QOF's liabilities) will, to the extent of such excess, constitute an inclusion event with respect to previously-deferred gains invested in to the QOF, and (ii) distributions can be recharacterized as a "disguised sale" that may cause such original contribution to become a non-qualifying contribution that is not eligible for the opportunity zone tax incentives noted above.

7. Reinvestment Period:
   A QOF is able to maintain statutory compliance after selling all or substantially all of its QOZP (whether held directly or indirectly) by reinvesting the proceeds of such sale in new QOZP within twelve (12) months after the initial sale. However, it should be noted that the new regulations state that any gain created in such a sale and occurring prior to an investor having reached a ten (10) year holding period would be taxable gain to investors at such time. Treasury stated that, although they do not feel that this is Congress's desired outcome, they did not have sufficient statutory authority to create a deferral or exclusion for these intermediate gains.

8. Exiting a QOF:
   Although the statutory language included in the TCJA suggests that a sale of an investor's interest in the QOF itself (as opposed to the underlying QOZP) may be necessary to recognize the gain exclusion associated with a ten (10) year holding period, the new regulations clarify that, after the ten (10) year holding period is satisfied, any capital gain passed-through to an investor's K-1 can be excluded – including a sale of underlying QOZP.

9. Anti-Abuse Rules:
   The new regulations also added a general anti-abuse rule that would eliminate the tax incentives in circumstances where the transaction is abusive, not consistent with the purpose of the opportunity zone program and/or primarily intended to achieve a tax result, even if technical compliance exists.

   While the foregoing list covers many of the key terms included in the proposed regulations, it is not exhaustive in scope. The proposed regulations are well over one hundred and fifty (150) pages long and densely packed with guidance on a variety of aspects of the opportunity zone program. Although the proposed

regulations make investment in opportunity zones much clearer and more compelling, and, we believe, further the stated policy goals of job creation and investment in these communities, we continue to recommend that you consult with your tax and legal advisors to ensure that your unique transactions can work within the complex and growing regulatory framework associated with the opportunity zone program.

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