
Guide to the Surprises Lurking in the QOZ Proposed Regulations

Legal Alert

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While mid-April is typically associated by most with Tax Day, this year, April 2019, also became the month the highly awaited second round of Qualified Opportunity Zone Proposed Regulations were issued.

With the enactment of the tax law in December 2017, we were introduced to this new concept and, with the first set of Proposed Regulations released in October 2018, several, but not all, questions were answered. Now, six months later, many remaining questions have been answered. This article presents some of the practical impacts of the Proposed Regulations. Subsequent articles will include those that specify the contractual representations and warranties that real estate developers and investors might wish to use to ensure the tax benefits are achieved and the projects are built.

By now, a lot of ink has been spilled across the country on Opportunity Zones and the base line tax benefits. Undoubtedly, contemporaneous with this article will be others synthesizing the rules. While we will leave that to others, a brief framework is in order.

Fundamental QOZ Framework

An individual or entity with capital gains realized after 2017 and before 2027 from any source (e.g. the sale of stock, not just from real estate) can defer paying tax on that capital gain to the extent the gain amount is invested within 180 days of realization in a Qualified Opportunity Fund (QOF). That gain can be deferred until as late as the end of 2026 as long as the funds remain invested in the QOF. Depending on the length of that investment period, 10% (for a five-year investment) or 15% (for a seven year investment) of the deferred gain can, in fact, be abated completely (under current law, to achieve the 15% abatement the investment must be made by December 31, 2019, and to achieve the 10% abatement the investment must be made by December 31, 2021). In addition, any tax on the gain from the new investment in the QOF can be entirely abated if the new investment in the QOF is held at least ten years. To be a QOF, the fund must itself be invested in tangible property (real or personal) or businesses located within certain specified zones, called Qualified Opportunity Zones (QOZ), located in economically disadvantaged census tracts designated by the governors of each state, and with some limitations, in contiguous census tracts. The Internal Revenue Code and Proposed Regulations, including the second set, delineate the quantum of time and criteria governing the investment necessary to satisfy the opportunity zone rules. Suffice it to say, for purposes of this article, if the QOF touches all bases, the investors should realize the tax benefits appropriate to their situation.

Surprises in the Proposed Regulations

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Here are a few of the most interesting and surprising results of the two sets of regulations that may not have been obvious until now:

1. Qualified Opportunity Zone Business Property and Original Use

- **Background:** Among the criteria necessary to meet the definition of Qualified Opportunity Zone Business Property is one that states that either (1) the original use of the tangible business property in the QOZ must commence with the QOF or (2) the QOF must make an expenditure on improvements that equal or exceed its investment in the property acquired within any 30-month period beginning after the date of acquisition. In order to be classified as a QOF the fund must hold at least 90% of its assets in Qualified Opportunity Zone Property (the 90% Asset Test).
- **Proposed Regulations:** Original use is determined by who placed the property in service for purposes of depreciation; if someone had depreciated the property before the QOF acquired the property it cannot be deemed to be original use property of the QOF in the QOZ, and therefore, must receive an additional investment equal to or exceeding the basis of the investment in the acquisition to satisfy the definition of QOZ Business Property.
- **Proposed Regulations:** Vacant buildings within the QOZ are an appropriate investment by the QOF. While it might seem that a vacant building cannot be original use property of a QOF, so long as it has been vacant and has not been depreciated by the seller for at least five years it can be classified as original use property of the QOF (meaning its use is treated as having commenced in the QOZ with the QOF). As such it then satisfies the first clause set forth above and **need not be substantially improved** (i.e. the QOF need not invest an amount that exceeds its basis in the vacant building).
- **Proposed Regulations:** The Proposed Regulations repeat the any 30 month period language from the Code without elucidation. On its face, it appears that the countdown does not have to commence on the date of acquisition, but once it commences there is a 30-month period for completion. While the consequences of this delay could impede the 90% asset test, there may be circumstances where it does not have a negative impact.
- **Proposed Regulations:** When a QOF sells or disposes of QOZ Business Property or otherwise receives a return of capital from a resulting distribution these proceeds are no longer QOZ Business Property and the QOF could fail the 90% Asset Test. The Proposed Regulations provide that so long as the proceeds are continuously held in cash, cash equivalents, and debt instruments with terms of eighteen months or less, and the proceeds are reinvested in QOZ Business Property within twelve months of the event, the proceeds will nevertheless be deemed to be QOZ Business Property for the 90% Asset Test. With a tip of the hat to reality, Treasury acknowledges that government action (zoning boards, for instance) can delay projects and consequently reinvestment; such delay will not cause a failure to meet the twelve month requirement. There is no stated time limit in that case.
- **Proposed Regulations:** Raw land and land underlying a structure is excluded from calculating the substantial improvement calculation. However, this liberalization will not be allowed to permit speculation in land. The Proposed Regulations prohibit an investor from sitting on land with no plan to improve it or with a plan to improve it only insubstantially within 30-months.

2. Leased Qualified Opportunity Zone Business Property

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- **Background:** QOZ Business Property can be either owned or leased. There are several rules concerning leased property, including:
- **Proposed Regulations:** While owned property cannot be acquired from a related person, using a 20% overlap rule, there is no such prohibition on leasing property from a related person so long as (1) the lease contains arms-length terms, (2) there is no prepayment that exceeds 12 months and, (3) with certain qualifiers, if the original use of the leased property did not commence with the lessee the lessee must also acquire other QOZ Business Property with a value that equals or exceeds the value of the leased property within no more than 30 months from the date the lessee takes possession of the leased property. In other words, Treasury is not compelling the lessee to make substantial improvements to the related lessors property but instead, using analogous rules, requiring the lessee to spend as much on other property in the QOZ.
- **Proposed Regulations:** The value of leased property is equal to the present value of the leased asset, using the AFR for the discount rate.

3. Qualified Opportunity Zone Business

- **Background:** A QOZ Business is a trade or business in which 70% of the tangible property owned or leased by it is QOZ Business Property, 50% of the gross income of the business is derived from the QOZ Business Property (among other rules) and is not the type of business contained in a list of prohibited ventures, described below.
- **Proposed Regulations:** There are four ways to satisfy the 50% Gross Income Test:
 1. By the proportion of the number of hours during the year performed by employees, independent contractors, and employees of independent contractors in the QOZ to the total number of hours these persons perform overall in that time frame.

While it does not say so, the only way for this to work properly is to use an overall number in the denominator that such persons perform for that QOF. Otherwise, the hours a true independent contractor works on other jobs having nothing to do with the QOF or with the QOZ will skew the results.
 2. By the proportion of the amount paid during the year to employees, independent contractors, and employees of independent contractors for work in the QOZ to the total amount paid to these persons overall in that time frame.
 3. The tangible property of the trade or business located in a [QOZ] and the management or operational functions performed in the [QOZ] are each necessary for the generation of at least 50 percent of the gross income of the trade or business.
 4. A facts and circumstances test.
- **Proposed Regulations:** Solely for the purpose of defining a QOZ Business (which is a baseline criterion for a corporations stock or a partnership interest to be a valid QOF investment), the ownership and operation (including leasing) of real property by the entity is considered the active conduct of a trade or business by the entity but not if the entity leases the real property it owns to a tenant subject to a triple net lease. The owner is now just a passive investor in real estate and is not running a QOZ Business; as such the QOF cannot count this investment as QOZ Business in computing its 90% Asset Test.
- **QUERY:** By limiting this rule solely to the definition of QOZ Business was Treasury allowing triple net leased real property to still qualify as QOZ Business Property?

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- **Observation:** The prohibited businesses are golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, gambling establishments, and stores that sell alcohol for off premises consumption. Nothing more and nothing less. With states now coming on line with both medical and recreational marijuana it appears from this list that a marijuana facility of any type would not be prohibited by this list. It is important to note that this list is not a creature of regulation but instead derived by statute; it would therefore take an act of Congress to change it. For Congress to do so it would have to acknowledge that notwithstanding the federal stance on marijuana it is a legal substance under the laws of several states. How Congress deals with this existential question will be very interesting to watch. Furthermore, an argument can be made that any marijuana facilities set up under the current formulation of the law will have to be grandfathered if the law were to change.

4. Notable Rules Governing the Investment

- Only net section 1231 gain from the sale of property used in business can be deferred.
- An investment can be made in-kind and qualify for deferral.
- Services to a QOF carried interests are not considered an investment resulting in an interest in a QOF that will qualify for tax benefits.
- A QOF interest can be acquired from an earlier QOF investor and qualify for the tax benefits.
- When the final reckoning comes on the deferred gain the gain will be recognized on the earlier of the date the QOF investment is disposed of or by December 31, 2026. Furthermore, if the deemed sale date is December 31, 2026, the amount of gain will be computed by subtracting the taxpayer's basis in the QOF investment on that date from the lesser of the remaining deferred gain or the fair market value of the QOF interest on that date. This is a gift! If the investment in the QOF is doing well the deferred gain ultimately recognized is capped at the amount deferred. If the investment is doing poorly it is possible the recognized gain can be lower than the amount deferred. Not only is the federal government reducing the amount recognized by increasing basis by up to 15% it is also indemnifying a portion of this investment by effectively stating that a taxpayer with a bad investment might avoid paying the tax on some or all of the 85% remaining deferred.
- Watch out for those who will try to artificially reduce values on December 31, 2026.

5. Inclusion Events that will accelerate the inclusion of gain

- Gain will be triggered if the QOF ceases to exist.
- Gain will be triggered if the QOF that is a corporation liquidates and distributes the QOF interests in a taxable transaction; the exception would be a distribution to an 80% distributee under section 337(a).
- A gift outright or in trust will trigger gain, but not a transfer by reason of death.
- While a contribution to a grantor trust or other disregarded entity will not be an inclusion event, the change in the transparent status of the grantor trust or DRE will trigger inclusion (with an exception for a change in status to a grantor trust due to death).
- Contributions to and distributions from a partnership or S corporation will be an inclusion event only if and to the extent gain is realized.
- The conversion of an S corporation to a Partnership or DRE is an inclusion event.

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Summary

QOZs represent a sweeping program that can have massive tax benefits to investors and economic revitalization to areas that have long been on the losing end of the economy. As we enter this new Emerald City we have to be cautious that the governments munificence is not met by foolhardy financial deals chasing tax benefits at the expense of true economic worth.

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