

# Client Alert

April 2019

## Opportunity Zone Update - IRS Issues Second Round of Proposed Regulations – Top Twenty Highlights

On April 17, 2019, the Internal Revenue Service (the “Service”) issued a second round of Proposed Regulations (REG-120186-18) (the “April Regulations”) providing an additional [169 pages](#) of guidance on the Opportunity Zone program.

The Tax Cuts and Jobs Act, P.L. 115-97, added new Section 1400Z-2 of the Internal Revenue Code (the “Code”) which created Qualified Opportunity Funds (“QOF”). An overview of the Opportunity Zone program was provided in our prior [client alert](#), including an overview of the tax benefits of an investment in a QOF. An overview of the first round of Proposed Regulations (the “October Regulations”) was provided in a subsequent [client alert](#).

The April Regulations provide answers to many (but not all) of the questions that were left open by the October Regulations, such as the definitions of “substantially all,” “active conduct of a trade or business” and “original use.” Overall, the April Regulations provide taxpayer-friendly guidance including the rules regarding reinvestment of proceeds received by a QOF for the sale of assets and the “original use” of land and vacant buildings.

### Highlights from the Proposed Regulations

The April Regulations answer many questions left open under the October Regulations and additional questions that have arisen since Congress enacted the Opportunity Zone program and the Service issued the October Regulations. The April Regulations also revise certain provisions contained in the October Regulations. This alert provides a summary of certain provisions of the April Regulations. Highlights of the April Regulations include:

1. **QOF Reinvestment Rule.** The April Regulations provide a 12-month period for the reinvestment of proceeds received by a QOF from the distribution, sale, or disposition of the QOF’s assets. Prior to reinvestment, the QOF must hold such proceeds in cash, cash equivalents or debt instruments with a term of 18 months or less. However, and regardless of the reinvestment of proceeds, the QOF or its investors are taxed on the gain from the sale or disposition of the QOF’s assets (but see #2 below). In addition, if a QOF investor’s interest in a QOF is reduced due to an “Inclusion Event” prior to December 31, 2026, the taxpayer must recognize its deferred gain. The April Regulations define 21 Inclusion Events and note that each of those transactions would reduce or terminate the QOF investor’s direct or indirect interest in the QOF. The rules related to the 21 Inclusion Events are complex and beyond the scope of the summary of the April Regulations in this client alert.
2. **Ten-Year Holding Period and the Sale of QOF Property.** The Opportunity Zone statute provides that if an investment is held for at least ten years, the taxpayer’s basis in the property will be the fair market value of the investment at the time of the sale or exchange of the investment. Many were concerned that a taxpayer had to sell its QOF interest in order to realize the ten-year benefit. However, the April Regulations provide that if a QOF partnership (or QOF S corporation) sells qualified opportunity zone property after the ten-year holding period, a taxpayer may elect to exclude some or all of the capital gain from the sale.

3. Zero Basis Rule Generally. A taxpayer's basis in its investment is zero under Section 1400Z-2(b)(2)(B)(i) of the Code. The April Regulations clarify that the increases to basis available after the investment is held for five or seven years are available with respect to: (i) suspended losses of an investment in a QOF partnership under Section 704(d) of the Code and (ii) after the recognition of deferred gain upon the earlier of December 31, 2026 or an Inclusion Event.
4. Zero Basis Rule and Refinancing. The April Regulations provide that a partner's basis in a QOF partnership is adjusted to take into account the partner's share of partnership debt under Section 752 of the Code. In addition, the April Regulations contain two examples related to a debt-financed distribution to a partner in a QOF partnership which conclude that the distribution of debt-financed proceeds to a partner in a QOF partnership are non-taxable to the extent of the debt allocation to the partner.
5. 90% Asset Test Relief. In order to provide relief to a QOF that receives an investment shortly before a 6-month 90% Asset Test date, the April Regulations allow a QOF to apply the 90% Asset Test without taking into account any investment received in the preceding six months as long as those investments are held in cash, cash equivalents or debt instruments with a term of 18 months or less.
6. Carried Interest. The April Regulations provide that a partnership interest in a QOF that is received in exchange for services (i.e., a carried interest) is not eligible for the various tax benefits associated with an investment in a QOF as services are not considered as making an investment for purposes of the Opportunity Zone program. If an investor in a QOF partnership also receives a carried interest, while the tax rules provide that a partner has a unitary basis and capital account in its partnership interest, for purposes of the Opportunity Zone program, the partner will be treated as holding two separate interests in the QOF as a mixed-funds partner with certain exceptions such as distributions from the QOF partnership as described in the April Regulations.
7. Investment in a QOF. The April Regulations provide that a taxpayer may make an investment in a QOF by transferring cash or other property to a QOF regardless of whether or not the transferor would recognize gain or loss on the property transferred. Note, however, that QOZB Property (defined below) is still subject to the requirement that property be acquired by purchase as defined in Section 179(d)(2) of the Code which requires, among other things, that the property be acquired from an unrelated person and that the basis of the property is not determined, in whole or in part, by reference to the basis of such property in the hands of the transferor.
8. Original Use of Property. In order to be "qualified opportunity zone business property" ("QOZB Property"), the original use of the property must commence with the QOF or the "qualified opportunity zone business" ("QOZB") or the QOF or QOZB must substantially improve the property. The April Regulations provide that "original use" of property commences on the date when that person or a prior person first places the property in service for purposes of depreciation or amortization. Thus, if a taxpayer other than the QOF or QOZB depreciated or amortized (or would have been allowed to depreciate or amortize) the property, original use does not begin with the QOF or QOZB and the QOF or QOZB must substantially improve the property.
9. Vacant Property and Original Use. The April Regulations provide that if a building or other structure has been vacant for at least five years prior to its purchase by a QOF or QOZB, the purchased building or structure will satisfy the original use requirement.
10. Land and Original Use. The April Regulations provide that the original use requirement is not applicable to land, whether the land is improved or unimproved, and the land is not required to be substantially improved. However, to prevent "landbanking," the land must be used in a trade or business of a QOF or QOZB. The mere holding of land would not satisfy this requirement.

11. Leased Property. The April Regulations provide numerous clarifications regarding a QOZB and leased property:
- *Criteria* - Leased tangible property must be acquired under a lease entered into after December 31, 2017 and at least 70 percent of the use of the leased tangible property must be in a qualified opportunity zone during at least 90 percent of the period for which the QOZB leases the property. The lease must provide for a “market rate lease”. In addition, the April Regulations do not require the leased property to be acquired from an unrelated person provided that two additional conditions are satisfied ((i) no prepayment of rent exceeding 12 months and (ii) within 30 months, the lessee must purchase tangible property that is QOZB property having a value not less than the leased property value).
  - *Original Use and Substantial Improvement* – The April Regulations do not impose an original use requirement with respect to leased tangible property. In addition, improvements made by a lessee to leased property satisfy the original use requirement. The April Regulations also do not impose a substantial improvement requirement regarding leased real property provided that there is no plan, intent or expectation that the QOF will purchase the real property for less than fair market value.
  - *Valuation of Leased Tangible Property* – For purposes of the 90% Asset Test, leased tangible property may be valued using either an applicable financial statement valuation method or an alternative valuation method.
12. Definition of “Substantially All” for Qualified Opportunity Zone Business Property. An entity is a QOZB if “substantially all” of the tangible property owned or leased by a trade or business is QOZB Property. The October Regulations defined “substantially all” as at least 70 percent, but the regulations did not define the phrase “substantially all” as used in the definition of QOZB Property. The April Regulations provide that property is QOZB Property if during at least 90 percent of the QOF’s holding period for such property, at least 70 percent of the use of such property was in a qualified opportunity zone.
13. Definition of “Substantially All” for QOF’s Holding Period. In order for stock or partnership interests in a QOZB to be qualifying assets in the hands of a QOF, the issuer of such stock or partnership interest must qualify as a QOZB during substantially all (at least 90%) of the QOF’s holding period.
14. QOZB and the 50% Gross Income Test. In order to qualify as a QOZB, the entity must derive at least 50 percent of its total gross income from the “active conduct of a trade or business” under Section 1397C(b)(2) of the Code within a qualified opportunity zone. The April Regulations provide three safe harbors and a facts and circumstances test for purposes of satisfying the 50% gross income test.
15. QOZB and Use of Intangibles. In order to be a QOZB, a “substantial portion”, which the April Regulations provide is at least 40 percent, of the intangible property must be used in the active conduct of a trade or business in the qualified opportunity zone.
16. QOZB and the Active Conduct of a Trade or Business. The October Regulations did not define what constitutes the active conduct of a trade or business for purposes the Opportunity Zone program and the QOZB requirements. The April Regulations define a trade or business for purposes of the Opportunity Zone program as a trade or business within the meaning of Section 162 of the Code. The ownership and operation (including leasing, provided the lease is not a triple-net lease) of real property used in a trade or business qualifies as the active conduct of a trade or business.

17. QOZB and Real Property Straddling a Qualified Opportunity Zone. For purposes of determining whether a business satisfies the requirements of Section 1397C(b)(2), (4) and (8) of the Code discussed above, the April Regulations adopt a similar rule to that provided in Section 1397C(f) of the Code. Accordingly if, the unadjusted cost of real property located within the qualified opportunity zone is greater than the unadjusted cost of real property outside of the zone and the real property is contiguous to the part of all of the real property inside the zone, then all of the property is deemed to be located in a qualified opportunity zone.
18. Holding Period of a QOF Investor. The April Regulations provide if an investor disposes of its interest in a QOF and reinvests in another QOF, the investor's holding period begins on the date of its investment in the second QOF, not the first QOF. However, the April Regulations also provide exceptions for certain mergers and acquisitions of QOF investments that allow for the tacking of a holding period in the initial investment in a QOF.
19. Working Capital Safe Harbor Revisions. The April Regulations make two changes to the working capital safe harbor provided in the October Regulations. First, the written designation for the planned use of working capital includes the development of a trade or business in the opportunity zone as well as the improvement of tangible property. Second, exceeding the 31-month period does not violate the safe harbor if the delay is due to waiting for government action on an application that is completed within the 31-month period.
20. Consolidated Return Rules and QOF Corporations. The April Regulations note that the consolidated return regulations and the Opportunity Zone program are incompatible and difficult to reconcile. Accordingly, the April Regulations provide (i) that a QOF C corporation owned by members of a consolidated group is not a member of a consolidated group and (ii) various other rules related to QOFs and consolidated groups.

The Service plans to issue additional rules regarding a QOF that fails to meet the 90% Asset Test and information reporting requirements for a QOF. The Service also plans to revise Form 8996 for tax years 2019 and beyond.

Please feel free to contact us with any questions regarding the April Regulations or the Opportunity Zone program.

## Contacts

**Laura Ellen Jones**  
ljones@HuntonAK.com

**Wyatt A. Deal**  
wdeal@HuntonAK.com

**Hilary B. Lefko**  
hlefk@HuntonAK.com

**Laurie A. Grasso**  
lgrasso@HuntonAK.com

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