

Insights: Alerts

Treasury Issues Second Round of Proposed Regulations Providing Additional Guidance for Making Investments in Qualified Opportunity Zones

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On April 17, 2019, the Treasury Department issued a second round of proposed regulations (the “Proposed Regulations”) addressing investments in Opportunity Zones under the Tax Cuts and Jobs Act of 2017. The first round of proposed regulations issued in October 2018 (the “Prior Proposed Regulations”) provided a good framework for taking advantage of the Opportunity Zone program, but left many questions unanswered. The Proposed Regulations provided needed clarity for some of these items, including investments in non-real estate related businesses located in Opportunity Zones as well as additional guidance regarding the treatment of leased property located in Opportunity Zones, an expansion of the working capital safe harbor and providing Opportunity Funds additional time to deploy or re-invest capital into qualifying investments. The following provides a summary of some of the key provisions of the Proposed Regulations:

Safe Harbors for Satisfying 50% Gross Income Test

A qualified Opportunity Zone business must derive at least 50% of its gross income from the active conduct of a trade or business in an Opportunity Zone. Prior to the issuance of the Proposed Regulations it was not clear how this test applied to non-real estate related businesses located in an Opportunity Zone. The Proposed Regulations provide three safe harbors, and a facts and circumstances test, for purposes of determining whether sufficient income is derived from a trade or business located in an Opportunity Zone to qualify as a qualified Opportunity Zone business. Under the Proposed Regulations, an Opportunity Zone business satisfies the 50% gross income requirement if any of the following are true:

- at least 50% of the services performed (based on hours) by employees and independent contractors for such business are performed in the Opportunity Zone; or
- at least 50% of the services performed for the business by employees and independent contractors are performed in the Opportunity Zone based on amounts paid for those services; or
- the tangible property of the business located in the Opportunity Zone and the management and operational functions performed for the business in the Opportunity Zone are each necessary to generate 50% of the gross income of the trade or business.

The Proposed Regulations provide several examples applying the above safe harbors to operating businesses located within an Opportunity Zone.

Treatment of Leased Tangible Property

The Prior Proposed Regulations did not address the treatment of leased property or improvements to leased property for purposes of the Opportunity Zone rules. The Proposed Regulations provide that leased tangible property (including real property) may be treated as qualified Opportunity Zone business property if (i) it is acquired under a lease entered into after December 31, 2017; and (ii) substantially all of the use of the leased tangible property is in an Opportunity Zone during substantially all of the period for which the business leases the property. In addition, the Proposed Regulations provide that improvements made by the lessee to leased property will satisfy the original use requirement for property to be treated as qualified Opportunity Zone business property. Finally, the Proposed Regulations permit leasing of property from related parties if certain requirements are met.

Expansion of Working Capital Safe Harbor

The Prior Proposed Regulations provided a safe harbor for reasonable working capital amounts held in a qualified Opportunity Zone business. The safe harbor in the Prior Proposed Regulations provided that working capital is reasonable if (i) the amounts are designated in writing for the acquisition, construction or substantial improvement of tangible property in an Opportunity Zone, (ii) the written schedule provides that the working capital assets must be spent within 31 months by the business, and (iii) the working capital assets are used in a manner consistent with the working capital schedule. The Proposed Regulations provide that a written designation for planned use of working capital may include the development of a trade or business in a qualified Opportunity Zone in addition to the acquisition, construction or substantial improvement of tangible property. The Proposed Regulations also permit multiple overlapping or sequential applications of the working capital safe harbor, provided each application satisfies the working capital safe harbor.

Provisions Providing Relief from Application of Semi-Annual 90% Asset Test

Following the release of the Prior Proposed Regulations several questions were raised regarding an Opportunity Fund's ability to satisfy the semi-annual 90% asset test when an Opportunity Fund either received new capital or sold an investment at or near the time of the Opportunity Fund's testing date. The Proposed Regulations addressed these items, a summary of these provisions is set forth below:

Exclusion of Recently Contributed Property

The Proposed Regulations provide Opportunity Funds with the ability to determine compliance with the 90% asset test without taking into account property contributed to an Opportunity Fund during the 6 month period prior to an applicable testing date, provided that (i) the contributed property was contributed solely in exchange for interests in the Opportunity Fund; and (ii) the amounts are held continuously in cash, cash equivalents or debt instruments with a term of 18 months or less from the date of the contribution to the date of the applicable asset test. This provision gives Opportunity Funds needed flexibility to raise additional capital and the time to

deploy this additional capital without running afoul of the 90% asset test. Under this provision Opportunity Funds can time their capital raises in order to give them up to 12 months to deploy new capital in Opportunity Zone investments.

Reinvestment of Sale Proceeds by an Opportunity Fund

The Proposed Regulations provide that proceeds received by an Opportunity Fund from the sale or disposition of an investment in qualified Opportunity Zone business property, qualified Opportunity Zone stock or qualified Opportunity Zone partnership interests are qualified Opportunity Zone business property for purposes of the 90% investment requirement provided the following requirements are met:

- The sale proceeds are reinvested during the 12-month period beginning on the date of the sale or other disposition in a qualifying Opportunity Zone investment; and
- Until the proceeds are reinvested, the proceeds are held in cash, cash equivalents and debt instruments with a term of 18 months or less.

This rule permits an Opportunity Fund a reasonable time to reinvest amounts received upon a disposition of a qualifying Opportunity Zone investment or property, without violating the 90% investment requirement.

Transactions Triggering Recognition of Deferred Capital Gains

One of the key benefits of the Opportunity Zone provisions under the Act is the deferral of the recognition of capital gains that are invested in Opportunity Funds. The Proposed Regulations address events that will trigger recognition of the deferred capital gains, focusing on events that reduce or terminate an Opportunity Fund investor's direct (or indirect, in the case of partnerships) equity investment in the Opportunity Fund, including distributions or property (including cash) from Opportunity Funds. Examples of events that may trigger the recognition of deferred capital gains are as follows:

- Taxable dispositions of all or a part of an interest in an Opportunity Fund
- Gifts of interests in an Opportunity Fund.
- Charitable donations of interests in an Opportunity Fund
- A more than 25% decrease in ownership of stock of an S corporation held by shareholders at the time the S corporation made an election to defer capital gains under the Opportunity Zone provisions
- Distributions of property to investors in Opportunity Funds (either a corporation or a partnership) in excess of the investor's basis in the Opportunity Fund
- Transfers of interests in an Opportunity Fund corporation in certain non-recognition transactions under Code sections 351, 355 and 368.

Treatment of Transfers of Interests in Opportunity Funds upon Death

The Proposed Regulations provide that transfers of interests in an Opportunity Fund upon the death of the investor does not trigger recognition of any deferred gains. In addition, the transferee of the deceased investor's interest steps into the shoes of the original investor and inherits the holding period and deferred gains from the

deceased investor.

Impact of Dispositions of Investments by an Opportunity Fund or Opportunity Zone Business

Under the Proposed Regulations the disposition of an investment by an Opportunity Fund is taxable to the Opportunity Fund (or its investors) unless the disposition was structured in a manner that qualifies for non-recognition under another provision of the Code (for example, Section 1031 (like kind exchanges), Section 1202 (small business stock exclusion), and other non-recognition provisions of the Code). The preamble to the Proposed Regulations provide that the disposition of an investment by an Opportunity Fund would not impact an investor's holding period in the Opportunity Fund or trigger any deferred capital gains. The Treasury Department has solicited additional comments on this issue.

The Proposed Regulations take a substantial step in providing clarity for investors making investments in Opportunity Funds and for sponsors of Opportunity Funds to deploy capital in Opportunity Zones. The Proposed Regulations also addressed issues relating to Opportunity Funds and their interaction with the consolidated return rules, partnership tax provisions and S corporation provisions of the Code, as well as contributions of property (other than cash) to an Opportunity Fund. We will follow up with further alerts addressing these items.

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