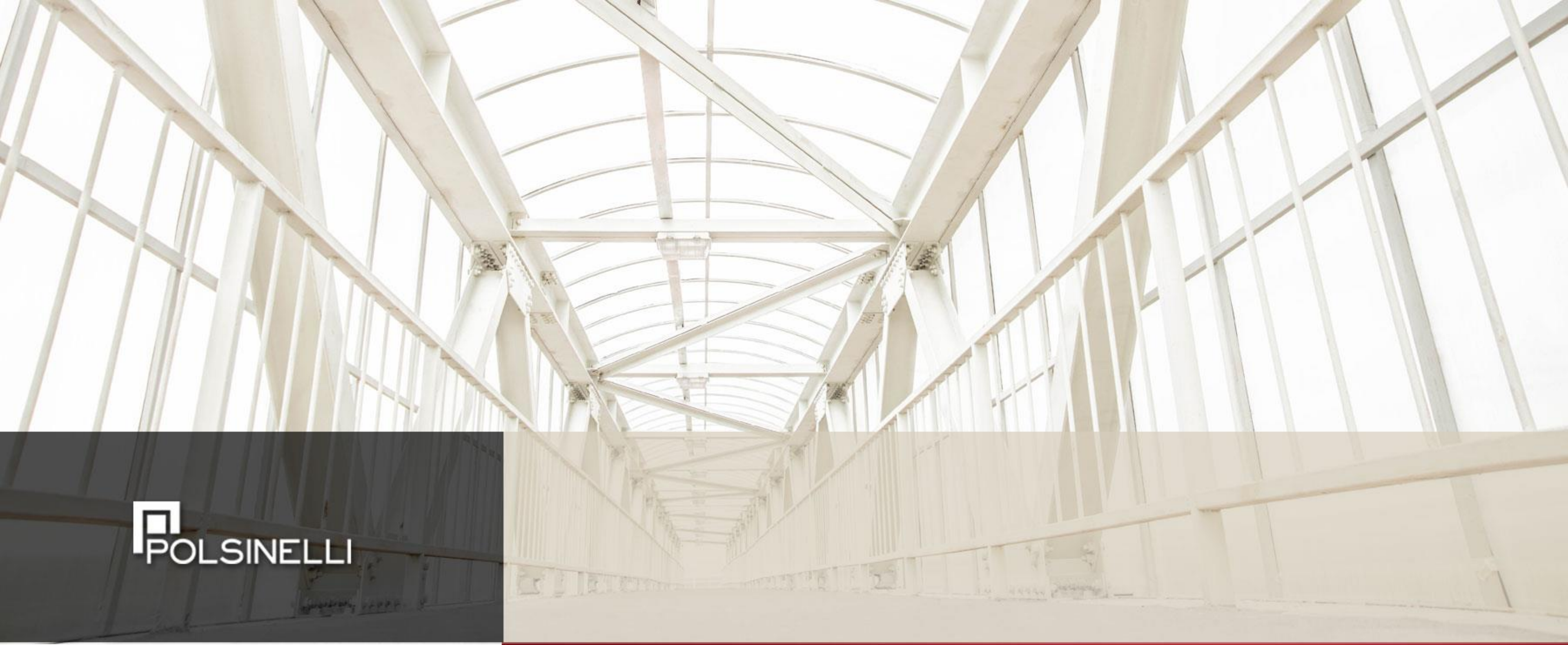

Opportunity Zones
2nd Tranche of Regulations and Market Commentary

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Second Tranche Of Proposed Regulations Issued by the IRS

On April 17, 2019, the IRS issued the second tranche of proposed regulations concerning the investing in Opportunity Zones.

- Addressed many of the remaining outstanding questions, but Treasury asked for comments regarding many of the provisions and noted that there will be at least one more set of regulations forthcoming.
- Provided many of the rules necessary to properly structure operating businesses.
- While not finalized yet, taxpayers are permitted to rely on these regulations if applied entirely and in a consistent manner.

Debt-Financed Distributions Allowed

Issue: Can investors receive a return of their deferred capital gains/equity by debt-financed distributions?

Guidance: The Proposed Regulations specifically approve partnership debt-financed distribution so long as the distribution does not exceed the investor's basis (as increased by the investor's share of the debt) in its QOF.

Polsinelli Practice Points:

- Business as usual for real estate development based projects – with substantial benefits of OZ provided to boost returns.
- Removes concern investor's equity would remain completely tied up for 10 years.
- Make sure you don't stub your toe on disguised sale rules.

Multi-Asset Fund Structures Permitted

Issue: The statute implied that in order to obtain the 10-year permanent exclusion benefit, an investor had to sell their investment in the QOF. This resulted in many funds being formed as single asset funds.

Guidance: The Proposed Regulations allow QOFs organized as partnerships, S corporations and REITs to sell their lower tier entities and, assuming that the investor has held the investment in the QOF for more than 10 years, the investor will pay no tax on the gain. This benefit does not apply to investors in QOFs organized as C corporations.

Polsinelli Practice Points:

- Clears up one of the biggest overhangs in the market by allowing fund sponsors to organize more traditional multi-asset fund structures.
- Still not an asset sale in a QOZB structure, as the Proposed Regulations appears to require that the Fund sell QOZB interests, rather than the QOZB sell the underlying asset itself.

Leasing Guidance

Issue: The 70% tangible property test requires property owned ***or leased*** by a QOZB to be qualifying property. This made determinations for operating businesses difficult, as it was uncertain (i) whether the value of leased real estate would be included as a "bad asset" and (ii) how to value leased property.

Guidance:

- Tangible property acquired under a lease entered into after December 31, 2017 will be qualified opportunity zone business property if the lease is a "market rate lease" and if at least 70% of the use of such leased property is used in a Opportunity Zone.
- The property does not have to be substantially improved or meet the original use requirement.
- This applies ***even if the property is leased from a related party*** provided the following two requirements are met:
  - The lease cannot also allow prepayments relating to a period of use exceeding 12 months;
  - During the term of the lease or 30 months (whichever is earlier), the lessee must become the owner of qualified opportunity zone business property whose value is at least equal to the value of the lease.

Polsinelli Practice Points:

- Otherwise non-qualifying property, such as land that was owned before 2018, can now be used by leasing to the QOZB (avoids bad land/good building analysis).
- Note that because the property is leased and not owned by the QOZB, the benefits of any appreciation of the property (such as the land), won't get OZ Benefits.
- Make sure to do a true lease analysis (could result in a bad QOZB asset if treated as owned by the QOZB for tax purposes).

Leasing as an Active Trade or Business

Issue: A QOZB must earn 50% of its total gross income from the active conduct of a trade or business. This has caused concern for leasing activities, as often simply leasing property has not been considered to rise to the level of an active trade or business.

Guidance:

- The Proposed Regulations specifically state that the ownership and operation (including leasing) of real property is the active conduct of a trade or business.
- However, the Proposed Regulations also state that "merely entering into a triple-net-lease" is not an active trade or business.

Polsinelli Practice Points:

- Firmly opens the door for many leasing activities to qualify, including the rental of single family residences.
- What constitutes "merely entering into a triple-net-lease"? If the QOZB has built or substantially rehabilitated the property before entering into a triple net lease, is that more than "merely"?
- Double-net lease on more than "merely"?

Section 1231 Gain Timing Restriction

Issue: How to deal with section 1231 Property (real or depreciable property used in a trade or business and held for more than a year).

- 1231 gains/losses are determined at the end of the tax year on an aggregate basis. Overall 1231 gain is capital gain; overall 1231 loss is ordinary.
- Problems: taxpayers may not know for sure whether they have 1231 gain until the end of the year
- Not really true – taxpayers can manage 1231 gains.

Guidance:

- 1231 gains can ONLY be invested in OZ during the 180 days beginning the last day of the taxable year. The regulations effectively eliminate the original 180-day window that beings on the date of the sale
- Gains from 1231 property sold on January 2, 2019 cannot be invested in OZ until at least December 31, 2019.
- Treasury's reasoning behind this rule is that a taxpayer cannot know whether there is any section 1231 gain until the end of the tax year.

Polsinelli Practice Points:

- Consult tax and legal advisors on past, current or future gain events.
- Retroactive? Treasury may have retroactively disqualified a significant number of early OZ investments.
- 1231 gains cannot be invested July – December of each year.
- May significantly reduce OZ investments during the last 6 months of each year.

Substantial Improvement is Asset-by-Asset

Issue: Under the substantial improvement test (“double the basis”) will it be measured on an asset-by-asset basis or is grouping of assets allowed?

Guidance: The Proposed Regulations state that whether property is substantially improved is made on an individual asset-by-asset basis. Treasury requested comments on allowing aggregate determination of substantial improvement.

Polsinelli Practice Points:

- If separate buildings exist on a parcel, presumably each building must itself be substantially improved to be qualified property.
- Even separate assets within a building or business must be substantially improved.
- Many businesses may have lots of separate assets to account for in determining whether QOZB meets the requirement that 70% of its tangible assets be qualified property.

Original Use

Issue: To be qualified property, the original use of property in an opportunity zone must commence with the QOF or QOZB, or it must be substantially improved. However, there was no definition of "original use" in the law or first set of proposed Regulations.

Guidance:

- Original Use of tangible property begins on the date when it is first placed in service inside the Qualified Opportunity Zone for purposes of the depreciation or amortization rules.
- Used property can satisfy the original use requirement so long as the property has not been previously used in the relevant opportunity zone such that it could be depreciated or amortized.
- Existing buildings and other structures can satisfy the original use requirement only if they have been vacant for at least five years.

Polsinelli Practice Points:

– QOF/QOZB purchases a development prior to the receipt of TCO - **APPROVED**
– Purchase and relocate operating businesses into opportunity zones – **APPROVED**
– Most rehabilitation of vacant property requires substantial improvement

31 Month Working Capital Safe Harbor Expanded

Issue: The working capital safe harbor originally applied only to the acquisition, construction and rehabilitation of tangible property. That would not really assist operating businesses with large expenses unrelated to tangible property. Also, the safe harbor was limited to 31 months, which might not even cover time to permit a project in certain areas

Guidance:

- The Proposed Regulations expand the working capital safe harbor to cover expenditures used in the development of an operating business.
- Safe harbor will not be lost if the expenditure of the working capital within 31 months is delayed by government action (assuming that permits etc. were requested within the 31 months)

Polsinelli Practice Points:

- Working capital expenditures for the development of a trade or business may include inventory and occupancy costs, and possibly payroll relating to start-up
- "California Rule" may free up more capital on the coasts for OZ investments
  - Make sure that needed applications and filings are made on time

50% of Gross Income "in the Opportunity Zone" Clarified

Issue: The first round of guidance stated, 50% of the gross income of a QOZB must be from "the active conduct of a trade or business **in the opportunity zone.**" How would treasury respond?

Guidance: The Proposed Regulations provide 3 safe harbors that meet this requirement, and a general "facts and circumstances" test. The safe harbors are:

- **Hours**: 50% percent of the services performed for the business, based on hours, are performed by employees and independent contractors in the opportunity zone;
- **Expenditures**: 50% of the services performed for the business, based on amounts paid for the services, are performed by employees and independent contractors in the opportunity zone;
- **Property/Functions**: Tangible property in the opportunity zone and management or operational functions performed in the opportunity zone are both required to generate 50% of the gross income of the business.

Polsinelli Practice Points:

- Original use, leasing and active trade or business rules mean the door is wide open to QOF investments in operating businesses.
- Substantial portion of intangible property (40%) must still be used in the zone – still ambiguous.

Carried Interests

Issue: The first round of proposed regulations provided that “special allocations” were permitted and could receive Opportunity Zone benefits. This clearly permits preferred returns for capital, but would its scope include carried interests received by the developer?

Guidance: The Proposed Regulations provide that any interest received in exchange for services is not a qualifying Opportunity Zone investment eligible for the 10-year benefit (the complete exclusion of additional gains) and that a service provider’s interest can be split between the qualifying investment relating to invested capital gains and the non-qualifying investment received for the performance of services.

Polsinelli Practice Points: Developers should consider clearly classifying which portion of their interest is in exchange for services (such as the development fee and management fees) and treat those as a non-qualifying investment. Developers may be able to receive special allocations on their qualifying investment portion of the interest (the portion received in exchange for capital gains) with careful structuring, but this will be an obvious area of scrutiny by the IRS moving forward .

Inventory

Issue: Does inventory count towards the asset tests? And because inventory isn't "placed in service" by the company, is there original use or substantial improvement?

Guidance: The Proposed Regulations clarify that inventory, including raw materials, can be considered a good asset. This includes any time period the inventory is in transit from a vendor to the Company's facility and from the Company to Company's customer.

The regulations did request comment regarding whether, in the alternative, inventor should be complete excluded from the asset test (both numerator and denominator).

Polsinelli Practice Points:

- Because inventory generally turns over relatively frequently, most inventory owned by a QOF/QOZB in an OZ will meet the asset tests requirements and will make it significantly easier for operating business to qualify (especially those where inventory is a high percentage of total assets.
- The in transit provision permits inventory to be included as a good asset even before it arrives in the zone and all the way in time up until final delivery to the company's customer.

Fund Management - QOF Cash

Issue: Qualified Opportunity Funds may accept gain contributions shortly before a testing date, and thereby fail the 90% asset test. Also, new opportunity funds may have a "ramp-up" period for its investments.

Guidance: The proposed regulations allow a QOF to apply the 90% test without taking into account any investments received in the preceding 6 months.

- New assets must be held in cash, cash equivalents, or debt instruments with term 18 months or less.

Polsinelli Practice Points:

- Cash held by a QOF during the first 6 months of the fund's existence will not count against the 90% test.
- If a QOF has only cash to start and no other assets, does it meet the 90% test?
- Regulations provide comment that even if the QOF fails its initial 90% test, this by itself does not cause the entity to fail to be a QOF.

Other Items

Contiguous Property

Real property outside of a OZ that is contiguous to part or all of the real property located inside the zone can be deemed to be located within the zone. The Proposed Regulations apply the Empowerment Zone rule of Section 1397(C)(f), which provides that so long as the real property (based on square footage) located in the OZ is greater than the amount of outside the zone, the contiguous property is deemed located within the zone.

Estate Planning

Gifts – Transferring a QOF interest by gift (other than a grantor trust disregarded from the transferor) is considered to be a disposition of the property and ends the deferral. The beneficiary does not get the 10 year benefits upon the beneficiary's subsequent disposition.

Transfer at Death – This is not an income inclusion event. The recipient of the QOF interest has the obligation to include the deferred taxes in 2026 (or earlier disposition if the recipient disposed of the QOF interest), and the recipient would get the 10 year benefit (tacking the decedent's holding period).

Interim Gains

Issue: How are sales of property by QOF or QOZBs treated for purposes of the investor's 10-year holding period, and are gains from these "interim" sales taxable?

Guidance:

- Sales or dispositions of assets by a QOF (or QOZB) do not affect investors' holding periods or trigger the inclusion of deferred gain so long as they do not sell or otherwise dispose of their investment in the QOF.
- QOF has 12 months to reinvest the proceeds from the sale or disposition before the funds will count against the QOF for purposes of the 90% asset test.
- QOF and its investors must recognize any gain on the sale of the assets

Polsinelli Practice Points:

- Opportunity Funds and QOZBs have a year to reinvest gains from the sales of property before having to worry about the 90% asset test.
- Gains from sales that occur before December 31, 2026 can be invested in a QOF and tax deferred, if only for a short time.

Regulatory Update

Questions?

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