Opportunity Zones Update

NEW PROPOSED TREASURY REGULATIONS
(PART II)

Qualified Opportunity Zone Businesses

May 21, 2019

Background

In December 2017, as part of the Tax Cuts and Jobs Act ("TCJA"), Congress established a new tax incentive program to promote investment in certain low-income communities designated by the IRS as qualified opportunity zones. The tax incentives obtained by investing in a qualified opportunity fund ("QOF") allow taxpayers to (i) defer paying taxes on capital gain from the sale or exchange of appreciated assets; (ii) receive a permanent exclusion from taxation of up to 15 percent of the originally deferred gain; and (iii) for taxpayers that hold their investment in the QOF for at least 10 years, a permanent exclusion from taxation for any appreciation in excess of the deferred gain.

On April 17, the Treasury Department released its second round of guidance on Opportunity Zone investments in the form of proposed regulations (the "New Proposed Regulations"). These newly proposed regulations supplement and in some cases revise the proposed regulations issued in October of 2018 (the "October Proposed Regulations"). [1]

The New Proposed Regulations provide further clarity, but leave many questions unanswered. This is Part II of our series of blog posts on the New Proposed Regulations. This post addresses key issues relating to the requirements for qualified opportunity zone businesses and qualified opportunity zone business property. For Part I of our explanation, which addresses qualified investments in qualified opportunity funds, please click on the link here.

[1] For a general discussion of the Opportunity Zone rules see our August 15, 2018 client update available here. For information on the first set of regulations issued with respect to these rules see our November 9, 2018 client update available here.

Guidance on the Requirements for Qualified Opportunity Zone Businesses

In order to qualify as a qualified opportunity fund (a "QOF"), a fund must have at least 90 percent of its assets invested in qualified opportunity zone property. Qualified opportunity zone property includes stock in a corporation and an equity interest in a partnership if the corporation or partnership is, or has been organized for the purpose of being, a **qualified opportunity zone business**.

The TCJA set forth specific requirements to be a qualified opportunity zone business. The October proposed Regulations and the New Proposed Regulations clarify and expand on some of these requirements.

In general, for a trade or business to be a qualified opportunity zone business (i) 70 percent or more of the tangible property owned or leased by the business must be qualified opportunity zone business property, (ii) at least 50 percent of the gross income of the business must be derived from the active conduct of a trade or business in a qualified opportunity zone, (iii) a substantial portion of the intangible property of the business must be used in the active conduct of the trade or business in the qualified opportunity zone, (iv) less than five percent of the average of the aggregate unadjusted basis of the property of the business may be from financial assets, and (v) the business must not be one of the so-called "sin businesses."

The 70 Percent of Tangible Property Test

To be a qualified opportunity zone business 70 percent or more of the tangible property owned or leased by the business must be qualified opportunity zone business property.

How is the 70 percent tangible property test measured?

Under the New Proposed Regulations the 70 percent test is determined by a fraction, the numerator of which is the total value of all tangible qualified opportunity zone business property owned or leased by the business and the denominator is the value of all tangible property owned or leased by the business.

How is the value of tangible property determined for the 70 percent test?

For purposes of the 70 percent test, a taxpayer that has certified audited financial statements (or financial statements that are required to be filed with the SEC or certain or other federal agencies) may (i) use the value of the property that is reported (or that would be reported) on their financial statement or (ii) use the unadjusted cost basis of tangible property <u>owned</u> by the business and use a present value method for tangible property <u>leased</u> by the business. Taxpayers without audited financial statements may use the method described in clause (ii).

In certain circumstances, a taxpayer may utilize the valuation methodology that is used for determining compliance with the 90 percent asset requirement.

Prior to the New Proposed Regulations, taxpayers with applicable audited financial statements were only permitted to use the value of the property reported on their financial statements.

The 50 percent of Gross Income Test

To be a qualified opportunity zone business at least 50 percent of the gross income of the business must be derived from the active conduct of a trade or business in a qualified opportunity zone.

How can a business meet the 50 percent gross income test?

The New Proposed Regulations provide three safe harbors and a facts and circumstances test that can be used to meet the 50 percent gross income test.

The three safe harbors are:

- **Hours-of-work safe harbor.** A business can rely on this safe harbor if at least 50 percent of the total hours of services performed by employees, independent contractors, and employees of independent contractors for the trade or business during the taxable year are performed in the opportunity zone.

- **Cost-of-services safe harbor.** A business can rely on this safe harbor if the total amount paid for services performed by employees, independent contractors, and employees of independent contractors in the opportunity zone is 50 percent or more of the total cost of services.

- **Business-functions-and-tangible property safe harbor.** A business can rely on this safe harbor if the management and operational functions performed in the opportunity zone and tangible property located in the opportunity zone are each necessary to generate at least 50 percent of the gross income of the trade or business.

In addition to these safe harbors, a business can look at its facts and circumstances to show that at least 50 percent of its gross income is derived from the active conduct of a trade or business in the qualified opportunity zone.

Does gross income from non-opportunity zone property count toward the 50 percent gross income test?

In some cases yes. Where an opportunity zone property and a non-opportunity zone property are contiguous and the opportunity zone property is substantial (based on square footage) in relation to the non-opportunity zone property, the non-opportunity zone property will be treated as if it is qualified opportunity zone property for purposes of the 50 percent gross income location test and the substantial use of intangible property test (described below). It is unclear what ratio of opportunity zone property to non-opportunity zone property will be considered substantial." The New Proposed Regulations do not adopt this rule for purposes of the 70 percent qualified opportunity zone business property test.

The Substantial Use of Intangible Property Requirement

To be a qualified opportunity zone business a substantial portion of the intangible property of the business must be used in the active conduct of the trade or business in the qualified opportunity zone.

What is "substantial" for purposes of the substantial use of intangible property in the active conduct of a trade or business in the qualified opportunity zone requirement?

The New Proposed Regulations clarify that the substantial use requirement for intangible property is met if at least 40 percent of the intangible property of the business is used in the active conduct of a trade or business in the qualified opportunity zone. As noted above, in some cases the use of intangible property in contiguous property that is not in an opportunity zone will count towards the 40 percent test.

What is the active conduct of a trade or business for purposes of the substantial use of intangible property requirement?

The New Proposed Regulations reserve on the definition of an active conduct of a trade or business but do state that the ownership and operation (including leasing) of real property is the active conduct of a trade or business provided that the activity is not merely entering into a triple net lease with respect to the property.

The 5 Percent Financial Assets Test

To be a qualified opportunity zone business less than 5 percent of the average aggregate unadjusted bases of the property of the business may be attributable to financial assets. For purposes of this test, a reasonable amount of working capital held in cash or cash equivalents with a term of less than 18 months is not treated as financial assets.

What is considered a reasonable amount of working capital for purposes of the 5 percent test?

The New Proposed Regulations expanded the working capital safe harbor established by the October Proposed Regulations working capital safe harbor. Pursuant to the safe harbor, an amount of working capital is reasonable if (i) the amounts are designated in a writing for the development of a trade or business in a qualified opportunity zone, (ii) there is a written schedule for the use of the funds within 31 months of the receipt of the working capital, and (iii) the working capital is actually used in a manner substantially consistent with the written description and schedule. Further, delays caused by slow government action (e.g. issuing of permits, zoning approvals, etc.) will not violate the requirements for the working capital safe harbor. Finally, the New Regulations make clear that a business can apply the safe harbor more than once such that subsequent funding may also rely on the safe harbor if the requirements described above are met.

Guidance on the Requirements for Qualified Opportunity Zone Business Property

Under the New Proposed Regulations, in order to qualify as **qualified opportunity zone business property ("QOZBP")** (i) the property must be tangible property acquired by the business from an unrelated party or leased after December 31, 2017, (ii) original use or substantial improvement requirements must be met, and (iii) during at least 90 percent of the holding period for the tangible property, 70 percent or more of the use of the property must be in a qualified opportunity zone.

What are the requirements for leased property?

For leased property to count as good opportunity zone business property, the lease must have been entered into after December 31, 2017, the terms of the lease must be arms-length market terms and the rate must be a market rate. Unlike in the case of purchased property, the lessor may be a related party (additional requirements apply if the lease is from a related party). In the case of leased real property there must not have been a plan or expectation for the business to purchase the leased property for other than its fair market value.

What counts as original use of leased or acquired tangible property?

The original use of leased tangible property commences on the first day the leased property is placed in service in the qualified opportunity zone for purposes of depreciation. For leased or owned tangible property that has been unused or vacant for an uninterrupted period of at least 5 years, the original use begins on the date after that period of unuse or vacancy when the property is placed in service. In addition, used tangible property that is acquired satisfies the original use requirement if the property has not been previously used in the opportunity zone. Special rules allow leased tangible personal property that does not meet the original use test to count as original use if the lessee becomes the owner of tangible property that is qualified opportunity zone business property having a value not less than the value of that leased tangible personal property and certain other requirements are met.

Do the New Proposed Regulations require a substantial improvement of land within the qualified opportunity zone?

It depends. The New Proposed Regulations make clear that land within a qualified opportunity zone need not be substantially improved. Such land can qualify as opportunity zone business property so long as it is used in the trade or business of the qualify opportunity fund or qualified opportunity zone business.

However, a qualified opportunity fund may not rely on this provision until the New Proposed Regulations become final in situations where the land is unimproved or minimally improved and the qualified opportunity fund or the qualified opportunity zone business purchases the land with an expectation, an intention or a view not to improve the land by more than an insubstantial amount with 30 months after the date of purchase.

How is inventory in transit treated for purposes of the 70 percent use in a qualified opportunity zone test?

The New Proposed Regulations make clear that inventory in transit from a vendor to a facility in the qualified opportunity zone, or from such a facility to a customer may be treated as property used in the qualified opportunity zone for purposes of the 70 percent test.

Conclusion

While it is important to remember that the New Proposed Regulations are not final, taxpayers may rely on the New Proposed Regulations prior to the date they become final (other than the section of the proposed regulations that addresses the rules for unimproved land so long as taxpayers apply the New and October Proposed Regulations consistently and in their entirety).

For assistance with establishing a qualified opportunity fund, or for additional information regarding qualified opportunity funds or opportunity zones in general, please contact the attorneys listed below.

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