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New Proposed O-Zone Regs May Be the Last, Officials Say

by Stephanie Cumings

A second set of proposed regulations on the Opportunity Zone program is an attempt to answer all the remaining questions about the program, according to Treasury officials.

While a third set of regulations had been expected, senior Treasury officials said during an April 17 press briefing that the new proposed regulations (REG-120186-18) will be the last unless it appears that a third set is necessary.

Some big issues addressed in the new regs include the active conduct of business rule, the working capital safe harbor, and issues related to land. But Richard C. LaFalce of Morgan, Lewis & Bockius LLP told *Tax Notes* that more questions will likely come up that need to be addressed in a third round of regulations, including questions on the interaction with subchapter K.

"They did a good job, but a lot of what was included in these regulations was already expected," LaFalce said. "However, I do think this will help investors start deploying funds for projects."

The Opportunity Zone program created by the Tax Cuts and Jobs Act allows for the deferral, reduction, and in some cases elimination of capital gains tax on some investments.

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Steven Hadjilogiou of McDermott Will & Emery said that the new regs should be helpful for operating businesses and will hopefully help the program expand beyond single-asset real estate deals. John Lettieri of the Economic Innovation Group agreed that the regs provide important clarifications for operating businesses, but said there are still some areas of concern.

Reinvestment Limitation

Lettieri said that although the regs provide a 12-month reinvestment period for proceeds, the clock for achieving the program's benefits starts over with the reinvestment.

"It's a pretty expansive compliance challenge," Lettieri said. "Now I have to keep track of each individual tranche of capital getting churned."

Lettieri said he's concerned that complexity will discourage the formation of small-scale, multi-asset operating business funds that are more community-focused. He said it could also discourage investment in start-up companies, which are inherently more unstable. The regs ask for comments on the potential burdens imposed if investors are required to "reset the holding period for reinvested realized gains, including administrative burdens and the potential chilling effect on investment incentives."

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Treasury Secretary Steven Mnuchin said at a White House event promoting the Opportunity Zone program that Treasury wants to "make sure we don't have a churn and burn," in which investors make an investment but then turn around and sell it.

Officials also clarified during the briefing that if an investor has held their interest in a fund for more than 10 years, they'll reap the program's benefits even if the fund sells underlying assets rather than the investor being forced to sell their interest, which they said should help facilitate multi-asset funds.

New Safe Harbors and Grace Periods

Under the initial set of proposed regulations (REG-115420-18) issued last October, a qualified Opportunity Zone business must derive at least 50 percent of its gross income from the active

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conduct of a trade or business within an Opportunity Zone, a requirement that raised concerns about how sales outside a zone would be treated.

The latest regs offer three safe harbors and a facts and circumstances test to satisfy that requirement, and officials said that meeting the requirement wouldn't be predicated on making sales within the zone.

The safe harbors that satisfy the 50 percent conduct rule are:

- 50 percent of the services performed based on hours are performed in the zone;
- 50 percent of the services performed based on amounts paid are performed in the zone; or
- 50 percent of the gross income of the business is necessarily derived from the tangible property and the management or operational functions in the zone.

"This change takes Opportunity Zones from a pure real estate play and makes it possible to invest in actual operating businesses, such as a business that sells goods or services," LaFalce said. Hadjilogiou said this safe harbor is even more expansive than the rule for the new markets tax credit, indicating that Treasury took the concerns about sales nexus seriously.

The first set of regs also included a proposed 31-month safe harbor under which a qualified Opportunity Zone business (QOZB) can hold cash as long as it has a written plan in place. The new regs say delays related to government approvals won't count against the 31 months. They also say the written plan for the safe harbor can now include "the development of a trade or business in the qualified opportunity zone as well as acquisition, construction, and/or substantial improvement of tangible property."

A six-month grace period has also been proposed for purposes of satisfying the 90 percent asset test, so that cash won't be counted against the test until it's been held for at least six months.

No Land Banking

Land can be treated as QOZB property "only if it is used in a trade or business of a [qualified opportunity fund] or qualified opportunity zone business," according to the regs, which add that "the holding of land for investment does not give rise to a trade or business."

However, the regs also provide that buildings or other structures that have been vacant for at least five years won't need to be substantially improved to qualify as QOZB property.

The regs also clarify the definition of QOZB property, including that leased property can qualify if specific conditions are met. Hadjilogiou said it's helpful that businesses won't be required to substantially improve leased property.

Hadjilogiou said there were also questions about what would constitute original use of a real estate project that had already been partially developed. The regs clarify that original use begins when the property is placed in service for purposes of depreciation or amortization. That means the buyer won't have to substantially improve the property if it hadn't yet been placed in service, Hadjilogiou said.

Under the statute, QOZB property is defined as "tangible property used in a trade or business of the qualified opportunity fund if" specific conditions are met, including that "during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone." The regs clarify that for purposes of the holding period, substantially all means 90 percent, and that for purposes of the use, it means 70 percent.

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The regs also contain a broad antiabuse provision that states that abuse will be determined "based on all the facts and circumstances."

OIRA Influence

Asked how the proposed regs were influenced by the review process at the Office of Management and Budget's Office of Information and Regulatory Affairs, the Treasury officials stressed that the regs were always a work in progress and that the review process isn't strictly linear. While the goal is to send regulations to

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OIRA once they're mostly complete, Treasury and the IRS continued to hold meetings to refine the regulations even after sending them to OIRA for review, the officials said.

Treasury also issued a request for information along with the proposed regs on how best to track and collect information on the program. Mnuchin said the IRS and Treasury hope to provide guidance on reporting requirements next. That guidance will hopefully strike a balance between not being "too bureaucratic" and ensuring proper reporting that allows the government to monitor the success of the program, he said.

The IRS scheduled a July 9 hearing on the new proposed regs. ■

Jonathan Curry contributed to this article.

O-Zone Regs Don't Address Practical Tiered-Partnership Issue

by Eric Yauch

The government clarified that a fund interest doesn't have to be sold to take advantage of a major Opportunity Zone benefit, but it's unclear how the proposed rule works in the more common tiered-partnership setting.

The second batch of proposed Opportunity Zone regulations (REG-120186-18), released April 17, allows qualified opportunity funds to sell assets and wipe out the capital gain on the sale as long as the partner's qualified fund interest was held for 10 years. But the vast majority of funds aiming to take advantage of the program don't own assets directly; they own other partnerships that in turn own the underlying assets.

Using the example of real estate owned by a partnership with a QOF investment that is sold 10 years later by a lower-tier partnership, Libin Zhang of Fried, Frank, Harris, Shriver & Jacobson LLP noted that the proposed regs don't specify whether the gain from that sale, which ultimately flows up to the fund investors, would remain tax free.

"They kind of met the taxpayer halfway; they only talk about directly sold interests by the fund," Zhang said.

Zhang said that the government wants input on several issues that remain outstanding regarding the finer points of the program, but it's not clear whether they'll be addressed by guidance. During a call with reporters April 17, senior Treasury officials indicated that a third round of new rules may not happen, even though further guidance had been expected.

"I'm not sure why there's mixed communication in that area, but they left some other stuff sort of open-ended," Zhang said.

The Opportunity Zone program, created by the Tax Cuts and Jobs Act, allows taxpayers to defer capital gains by investing in QOFs or qualified businesses. Investments held in a QOF for at least five years get a 10 percent basis step-up in the original gain, which climbs to 15 percent after seven years. Gains accrued in a fund can escape taxation entirely if the investment is held for at least 10 years.

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