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IRS Releases Second Set of Proposed Regulations Regarding Qualified Opportunity Funds

On April 17, the IRS issued proposed regulations that provide new guidance for investors seeking to invest in qualified opportunity funds (each, a QOF), a new investment program designed to incentivize long-term investment in economically distressed communities throughout the United States. Under Section 1400Z of the Internal Revenue Code (the code), investors that invest in certain designated low-income census tracts known as "qualified opportunity zones" (each, a QOZ) through a QOF are eligible for a range of potential tax benefits, which can include both deferral and a 15 percent reduction of tax on capital gains as well as elimination of tax on appreciation upon selling one's QOF investment. Despite these tax incentives, many believed that the IRS needed to promulgate more comprehensive guidance in order to enable the QOZ program to have wide participation and make its intended impact on economic development. Consequently, the IRS responded on October 18, 2018, by issuing proposed regulations that addressed many outstanding issues but also left several significant questions unanswered. Day Pitney previously published an article discussing the first set of proposed regulations, which can be found here. The latest IRS release containing the proposed regulations, which were issued on April 17, provides 169 pages of additional guidance for investors seeking to participate in the QOZ program. **Highlights of the Proposed Regulations**

1. *Investors can benefit from the 10-year rule without disposing of their QOF investment.* One of the key benefits of the QOZ program is the "10-year rule," which permits a taxpayer that holds a QOF investment for at least 10 years to elect to increase the investor's basis in such investment to the fair market value of the investment on the date that the investment is sold or exchanged. This basis "step-up" enables investors to exit their QOF investment without paying tax on the investment's appreciation, but the *statutory* language does not afford similar treatment to a QOF held for more than 10 years that sells appreciated qualified property. Rather, a QOF that sells its appreciated qualified property recognizes gain upon the sale, gain that is then allocated to the QOF's owners via Schedule K-1 if the QOF is structured as a "pass-through" (partnership or S corporation). This distinction created an incentive to structure QOFs as "single asset" entities instead of placing multiple appreciable assets in a single QOF. The regulations lessen this distinction by providing that a taxpayer that invests in a QOF structured as a pass-through entity may elect to exclude from gross income capital gain from the disposition of qualified property reported on Schedule K-1 of such entity, provided that the disposition occurs after the taxpayer's 10-year holding period. Notably, this rule does not extend to QOFs structured as C corporations, which must still pay entity-level tax on the disposition of qualified property regardless of holding period. 2. *Previously undefined usages of a "substantially all" standard have been defined.* In order for tangible property to constitute "QOZ business property," Section 1400Z states that "substantially all" of the QOF's use of the property must take place in a QOZ during "substantially all" of the QOF's holding period of such property. The same rule applies to qualified business property held by a QOZ business.

However, the phrase "substantially all" was previously undefined in this context, making it difficult for QOFs and QOZ businesses to assess how to satisfy their respective asset tests. The regulations clarify that "substantially all" of the use means at least 70 percent, and "substantially all" of the holding period means at least 90 percent.

3. *Rental real estate constitutes an active trade or business.* Section 1400Z provides that a QOZ business must satisfy various tests applied via cross-reference to Section 1397C. One such test requires that at least 50 percent of a QOZ business's gross income be derived from the active conduct of a trade or business in a QOZ. However,

neither Section 1400Z nor the first set of proposed regulations define an "active" trade or business in this context. Section 1397C(d)(2), which is not explicitly cross-referenced by Section 1400Z, excludes the rental of residential real property to others from the definition of a "qualified business." These uncertainties made it difficult for investors seeking to own and operate a residential real estate rental business in a QOZ to determine whether they could structure their ownership via a QOZ business or if only a QOF, which is not subject to a 50 percent active trade or business requirement, could own the property. The regulations alleviate this concern by stating that the ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business for purposes of the 50 percent active income requirement, which is clearly a taxpayer friendly result. 4. *QOZ businesses can satisfy one of three safe harbors to meet the 50 percent active income requirement.* Importantly, QOZ businesses not engaged in a real estate business were also unsure as to whether income derived from their activities would be considered derived from the active conduct of a trade or business in a QOZ. In response, the regulations provide three new safe harbors for the active trade or business test. These three safe harbors are met if

i. at least 50 percent of the services performed (based on hours) for the QOZ business by its employees and independent contractors (and employees of independent contractors) are performed within the QOZ ii. at least 50 percent of the services performed (based on amounts paid) for the QOZ business by its employees and independent contractors (and employees of independent contractors) are performed within the QOZ; or iii. the tangible property of the QOZ business in the QOZ and the management or operational functions performed for the QOZ business in the QOZ are each necessary to generate 50 percent of the gross income of the QOZ business.

While a QOZ business should aim to meet one of these three safe-harbor tests, the regulations also provide that income might still be deemed to constitute active trade or business income absent meeting one of these safe harbors based on the particular facts and circumstances.

5. *Other key issues addressed.* The regulations provide other rules regarding a wide variety of issues. For example, the regulations discuss how certain estate planning considerations such as inter vivos gifting, testamentary transfers, and the use of grantor trusts and single-member limited liability companies interplay with Section 1400Z. The regulations also reaffirm that QOF and QOZ business "recycling" strategies do not avail investors of the benefits of Section 1400Z, largely due to the Treasury Department's determination that implementing rules in favor of "investment churn" would exceed the authority granted to the Treasury Department and the IRS to issue proposed regulations. Notably, the regulations also set forth a variety of circumstances that would result in the inclusion of deferred gain, including common distributions and corporate restructuring techniques, that will materially impact QOFs and their investors. Finally, the regulations also provide QOFs with much-needed time to deploy contributed capital as well as to reinvest proceeds from the disposition of qualified property without violating the requirement that 90 percent of a QOF's assets constitute qualified property, which does not include cash, at various points during the QOF's taxable year.

Day Pitney anticipates releasing a second client alert shortly in order to address these and other new developments introduced by the regulations that will impact both investors and fund managers seeking to participate in the QOZ program.

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