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IRS Issues New Proposed Regulations on Qualified Opportunity Zones

Impact Investing Alert

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Significant tax incentives for investing in qualified opportunity funds (“QOFs”) that make qualifying investments in low-income census tracts designated as qualified opportunity zones (“QOZs”) were signed into law in December 2017 as part of the legislation known as the Tax Cuts and Jobs Act. Although initial proposed regulations were issued by the IRS in October 2018, many participants have remained hesitant to take advantage of the new program due to numerous unresolved issues. On April 17, 2019, the IRS issued a highly anticipated second round of proposed regulations (the “New Regulations”), which address many of the open issues and, to some extent, modify the provisions of the October 2018 regulations. While not all questions have been answered, the New Regulations are (for the most part) investor-friendly, and may provide sufficient comfort to enable investors, developers, and fund sponsors to move forward with QOZ-based projects.

This Alert provides an overview of certain key elements of the New Regulations, with an emphasis on tax benefits and deal structure considerations. For a more detailed background regarding the QOZ statutory framework and the impact of the October 2018 regulations, we refer you to our previous Alert on this subject.

Overview of the QOZ Program

Generally, federal income tax benefits for an investment in a QOF are available on an elective basis to an investor who (i) has a capital gain from the sale or exchange of property before the end of 2026 and (ii) reinvests the amount of such gain into a QOF within 180 days after the date on which the gain otherwise would be recognized. The capital gain that is “rolled over” into the Fund within the 180-day reinvestment period is deferred until December 31, 2026 (or, if earlier, the date on which the investment is sold or exchanged). In addition, the investor’s tax basis in the Fund (initially deemed to be zero) is eligible for a “step-up” that has the potential of permanently eliminating 10% of the deferred gain if the investment in the QOF is held for five years, and an additional 5% of the deferred gain (for a cumulative amount of 15%) if the investment in the Fund is held for seven years, provided that these holding periods are met by December 31, 2026.

Most significantly, for investments in the Fund held for at least ten years, the basis of the investor’s interest in the QOF is “stepped up” to its fair market value when the investment is sold or exchanged, having the practical effect of excluding 100% of the capital gain attributable to any appreciation in value of the investment in the QOF (as contrasted with the capital gain that is deferred at the time of the original rollover).

The tax benefits for a qualifying investment in a QOF are available only if at least 90% of the QOF's assets consist of qualified opportunity zone property ("QOZ Property") located in a QOZ. For this purpose, there are three categories of QOZ Property that may be owned by the QOF: (i) qualified opportunity zone business property ("QOZ Business Property"); (ii) qualified opportunity zone stock ("QOZ Stock") in a corporation that qualifies as a qualified opportunity zone business ("QOZ Business"); and (iii) a qualified opportunity zone partnership interest ("QOZ Partnership Interest") in a partnership that qualifies as a QOZ Business. A key structural consideration for any QOF is that the QOF may own QOZ Business Property either directly in its own right under a one-tier structure, or indirectly through the ownership of QOZ Stock or QOZ Partnership Interests in lower-tier entities that meet the tests for a QOZ Business under a two-tier structure (such lower-tier entities are sometimes referred to as operating subsidiaries even though the QOF is not required to have a controlling interest).

Impact of New Regulations on QOZ Tax Benefits

The New Regulations provide several helpful clarifications regarding the nature of QOZ tax benefits, the manner in which they may be obtained, and the circumstances in which the benefits may be forfeited due to a premature disposition of the taxpayer's investment, including the following key provisions:

Purchase of Interest in QOF from Existing Owner

Based on the wording of the statute, many people had assumed that a rollover of capital gain into a QOF would require the investor to make a capital contribution *to the QOF* in exchange for an equity interest issued by the QOF. Somewhat surprisingly, the New Regulations extend rollover treatment to an investor's acquisition of an equity interest in the QOF *from an existing investor* (although the purchaser would not inherit the seller's holding period). This new provision may facilitate the creation (or enhancement) of secondary markets for QOF investments until the end of 2026 (when the ability to make rollover investments expires), because investors in QOFs who need to exit the fund before the end of 2026 may find that there is a greater pool of prospective purchasers for their equity interests, particularly if the fund itself is no longer seeking fresh capital. In addition, it may help avoid some of the complexities associated with funds that otherwise might be relying on staged equity closings.

There has been no change to the requirement that a QOF's equity interest in an operating subsidiary (as distinguished from an investor's equity interest in a QOF) is treated as a QOZ Partnership Interest or QOZ Stock only if the equity interest is issued by the subsidiary entity (i.e., the QOF cannot acquire its equity interest in the subsidiary from an existing partner or shareholder).

Investment of Property Other Than Cash

The New Regulations include complex rules under which an investor is permitted to make a rollover of capital gain into a QOF by contributing property *other than cash*, either by capital contribution to the QOF or as consideration for the purchase of an existing investor's interest in the QOF under the new rule described above. Special rules apply for purposes of determining the amount of the investor's qualifying investment in the QOF. While the ability to contribute property other than cash may at first glance seem to add much flexibility – particularly if the contribution is made to the QOF on a tax-deferred basis – it is not clear whether this new rule will be of much practical significance, in light of the fact that property received by a QOF in a tax-deferred contribution will not qualify as QOZ Business Property (due to the presence of a carryover tax basis).

There has been no change to the requirement that a QOF's equity interest in an operating subsidiary (as distinguished from an investor's equity interest in a QOF) is treated as a QOZ

Partnership Interest or QOZ Stock only if the equity interest is issued in exchange for a contribution of cash.

Carried Interests Not Eligible

Services rendered to a QOF (or an entity in which the QOF holds a direct or indirect equity interest) are not treated as a qualifying investment in the QOF. As a result, so-called “carried interests” or “promotes” issued by a QOF will not be eligible for QOZ tax benefits.

Rollover for Section 1231 Gains

Generally speaking, under the New Regulations, “Section 1231 gain” from the sale of a business asset (such as long-term gain from the sale of rental real estate) can be rolled over into a QOF by an individual investor only after certain calculations are made for the taxable year of sale to confirm, after “netting” the investor’s Section 1231 gains and losses from all sources, that the Section 1231 gain from the specific property subject to the rollover election will be treated as capital gain. This means that the investor won’t know whether a particular Section 1231 gain will be eligible for rollover until the end of the year. The investor would then have 180 days, measured from the end of the year in which to make a rollover investment into a QOF (a potential trap for the unwary, since the 180-day period would not start to run on the date of sale).

This new rule should be contrasted with the QOZ rules that apply to sales of capital assets such as publicly traded stock, under which a rollover generally would be permitted for a particular capital gain transaction (with the 180-day period generally measured from the date of sale), even if the gain from the particular sale subject to the rollover election would otherwise be wiped out by capital losses from other transactions during the same year.

Ten-Year Capital Gain Benefit Generally

The principal tax benefit of the QOZ program is the elective step-up in basis for an investor’s equity interest in the QOF if the investor exits the fund after a ten-year holding period. This basis step-up is economically equivalent to a 100% capital gain exclusion for the appreciation in value of the investor’s investment in the QOF (as distinguished from the deferred capital gain that is initially “rolled over” into the fund). The New Regulations confirm that the step-up applies only to the investor’s “qualifying” investment in the QOF – i.e., the portion of the investment that is attributable to a rollover of capital gain within the preceding 180 days – so that an investor is not eligible for the ten-year capital gain benefit to the extent that the investor’s total investment in the fund exceeds the amount of his rollover capital gain. In addition, the New Regulations clarify that if a QOF is classified as a partnership for tax purposes, the step-up in an investor’s basis in his QOF partnership interest is calculated by taking into account the investor’s allocable share of partnership liabilities, thereby avoiding what would have been an adverse tax result on the sale.

Ten-Year Capital Gain Benefit Applies to Sale of Assets Directly Owned by QOF

Based on a literal interpretation of the statute, the ten-year capital gain benefit is limited to a disposition of an investor’s investment *in the QOF* – leading to concerns that the benefit would not be available upon a sale of assets owned by the QOF (whether directly by the QOF or indirectly by a subsidiary partnership in which the QOF owns a QOZ Partnership Interest). The New Regulations address this issue in mixed fashion.

The good news is that the ten-year capital gain benefit would be extended to a sale of QOZ Property owned *directly* by a QOF classified as a partnership or an S corp. – meaning that an investor with a ten-year holding period in the QOF would be able to exclude her Schedule K-1 share of capital gain recognized upon the QOF’s sale of “good” assets held directly by the QOF; i.e., (i) directly owned QOZ Business Property, (ii) a QOZ Partnership Interest, or (iii) QOZ Stock.

It appears that this new exclusion would be available even if the QOF's holding period in the property sold by the QOF is less than ten years (provided that the investor herself has a ten-year holding period in her QOF partnership interest or S corp. stock).

However, the new exclusion would not apply to any assets sold by the QOF that do not qualify as "good assets" for purposes of the 90% test – unlike the ten-year capital gain benefit available to an investor selling her equity interest in the QOF (in which case the entire appreciation in value of the investor's QOF equity interest is eligible for the capital gain benefit, even though up to 10% of the QOF's assets may consist of "bad assets").

It should be emphasized that the new capital gain exclusion would not apply to any ordinary income recognized upon the sale of assets by the QOF (such as depreciation recapture with respect to tangible personal property) – unlike the ten-year capital gain benefit available for the sale of an investor's equity interest in the QOF (in which case ordinary income would not be recognized to the extent described below).

Ten-Year Capital Gain Benefit Apparently Not Available Upon Sale of Assets by Subsidiary Partnership

For unexplained reasons, a literal reading of the New Regulations indicates that the ten-year capital gain benefit would not be extended to a sale of assets by a subsidiary partnership in which the QOF owns a QOZ Partnership Interest. It is not clear whether this restrictive approach was intended by the IRS. For those QOFs which utilize a two-tier structure in which each QOZ-based investment is owned by a separate subsidiary partnership, this limitation on the scope of the capital gain benefit may create an incentive for an ultimate exit event to be structured as a sale of the QOF's partnership interest in the subsidiary (rather than as a sale of the subsidiary's assets). In appropriate cases, depending on other variables, there might also be an incentive for sponsors to utilize a one-tier structure in which each QOZ-based investment is owned by a separate wholly owned limited liability company. Numerous factors beyond the scope of this Alert (both tax and non-tax) will enter into the decision of how to structure a QOF investment and how to exit the investment after the requisite ten-year holding period, and it remains to be seen how the marketplace will adjust to the nuances of the ten-year capital gain rule.

No "Recapture" on Sale of Interest in QOF After Ten-Year Holding Period

In the case of a QOF classified as a partnership for tax purposes, it is not clear under the statute whether an investor's basis step-up in the QOF (commonly referred to as an "outside" basis step-up) would avoid triggering ordinary income or other items of "look-through" gain determined under partnership tax rules. The New Regulations clarify this issue by requiring the QOF to adjust the basis of its assets (commonly referred to as an "inside" basis adjustment) immediately before the sale of the investor's partnership interest in the QOF. This inside basis adjustment would have the effect of enabling the investor to avoid ordinary income or other look-through gain that otherwise would have been triggered under partnership tax rules. However, it is not entirely clear under the New Regulations whether this inside basis adjustment would also apply to look-through items attributable to a subsidiary partnership in which the QOF owns a QOZ Partnership Interest.

Acceleration of Deferred Gain on Certain "Inclusion Events"

Under the statute, the deferred capital gain that an investor has rolled over into a QOF (net of the 10% and 5% basis step-up amounts, if applicable) is recognized on December 31, 2026, or, if earlier, upon the date that the investor's interest in the QOF is "sold or exchanged." The New Regulations contain detailed rules under which certain disposition events – referred to in the regulations as "inclusion events" – are treated as a sale or exchange for purposes of accelerating recognition of the deferred gain, even though such disposition events are not necessarily treated as a "sale or exchange" in ordinary tax parlance. Although a complete listing is beyond the scope of this Alert, examples of inclusion events include: (i) with respect to a QOF classified as a partnership for tax purposes, a distribution by the QOF to an investor if the amount of cash and fair market value of any other property distributed exceeds the partner's "outside" basis in his QOF partnership interest; (ii) with respect to a QOF classified as a corporation for tax purposes, certain types of corporate reorganizations and other nonrecognition transactions; (iii) in the case of an S corporation that owns an interest in a QOF, a more-than-25% shift in ownership of the S corp.; and (iv) other transactions having the effect of reducing or terminating the QOF investor's direct or indirect investment in the QOF.

Partnership Debt

In connection with the new inclusion event rules, the New Regulations clarify that a partner in a QOF classified as a partnership for tax purposes is entitled to take into account his share of QOF liabilities in calculating the "outside" basis of his partnership interest in the QOF, thereby (i) making it feasible for a QOF partnership to make debt-financed distributions to the extent of the investor's outside basis without triggering an investor's deferred gain, and (ii) enabling the investor to be able to deduct his share of QOF tax losses to the extent of his outside basis (subject to other limitations). However, even if a distribution by a QOF partnership does not exceed the investor's outside basis, there is a special anti-abuse rule (based on the principles of the partnership "disguised sale" rules) under which a distribution that was contemplated at the time of the investor's original contribution might cause a portion of the investor's investment to be disqualified (particularly if the distribution is made within two years after the original investment).

Estate Planning Considerations

As part of the new "inclusion event" rules noted above, the New Regulations provide useful guidelines relating to gifts, trusts, and estates, including the following:

- A gift of an investor's interest in the QOF, whether outright or in trust (including a gift to charity) generally *will* be treated as an inclusion event that triggers the donor's deferred gain.
- A gift of an investor's interest in the QOF to a trust treated as a "grantor trust" for income tax purposes will *not* be treated as an inclusion event (nor, for that matter, will a transfer to a wholly owned LLC classified for tax purposes as a disregarded entity, whether or not related to the investor's estate planning).
- Transfers by reason of an investor's death are generally *not* treated as inclusion events, including (i) a transfer to the deceased owner's estate, (ii) a distribution by the estate to its beneficiaries, and (iii) the passing of a jointly owned interest to the surviving co-owner by operation of law. However, the deferred gain will not be eliminated upon death; instead, the deferred gain will be subject to eventual recognition by the decedent's estate or heirs. For this purpose, the estate and heirs will step into the shoes of the decedent with respect to the various QOZ holding periods.

Rollovers by Members of Consolidated Group

The new regulations contain complex rules for affiliated groups of corporations that file consolidated income tax returns. Perhaps of greatest interest, (i) the member of a consolidated group that invests in a QOF must be the same corporation that generates the capital gain subject to rollover, and (ii) a QOF classified as a C corp. cannot be a included as a subsidiary member of the consolidated group (although it can be treated as the common parent corporation of the group).

Anti-Abuse Rules

The new regulations contain a broad anti-abuse rule which would give the IRS the right to recast any transaction (or series of transactions) having a significant purpose to achieve tax results inconsistent with the intent of the QOZ rules.

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Impact of New Regulations on Fund Qualification

The New Regulations contain several significant provisions regarding the QOF qualification requirements, including the following:

Exclusion of Recent Capital Contributions on Semi-Annual Testing Dates.

Although the "working capital" exception available to an operating subsidiary within a two-tier structure (discussed later in this Alert) has *not* been extended to QOFs, the New Regulations do provide additional relief at the QOF level for purposes of applying the 90% asset test. Specifically, the New Regulations allow a QOF to apply the 90% test (which generally applies every six months) without taking into account new capital received from investors within the preceding six months, provided that the new assets are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. This new rule addresses the concern that a QOF receiving a capital contribution shortly before a semi-annual testing date might not have sufficient time to acquire QOZ Property.

Reinvestment of Return of Capital Proceeds

The statute directs the Treasury to issue regulations that would give a QOF a reasonable period of time to reinvest the return of capital from its investments in QOZ Property. The New Regulations provide that the proceeds received by the QOF from its sale or other disposition of QOZ Property will not cause the QOF to flunk the 90% asset test, provided that (i) the QOF reinvests the proceeds in QOZ Property within 12 months and (ii) until the reinvestment occurs, the proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less. It should be emphasized that this 12-month grace period would not allow the QOF to avoid recognizing gain on the sale of the relinquished property (unless, among other possible exceptions, the sale is eligible for the newly expanded ten-year capital gain exclusion mentioned above). However, even if the sale of QOZ Property is treated as a taxable event, it would not trigger the inclusion of an investor's originally deferred gain or affect an investor's holding period in her QOF investment.

Asset Values Used in Applying 90% Test

The New Regulations give the QOF a choice between two methods of valuation in applying the 90% asset test for each taxable year (provided that the method chosen is applied consistently to all assets during the year).

- If the QOF has "applicable financial statements" (consisting generally of financial statements filed with the SEC or certain other federal agencies, as well as audited financial statements prepared in accordance with GAAP), the QOF may use the asset values reported on those financial statements in applying the 90% test.
- Alternatively, the QOF may value its assets based on their "unadjusted cost basis" (rather than "cost" as provided in the October 2018 regulations).
- Giving the QOF the choice between these two valuation alternatives provides relief from the approach taken in the October 2018 regulations, under which a QOF with applicable financial statements would have been required to use those statements in applying the 90% test.
- Special modifications are required for leased property in the hands of a lessee (described later in this Alert).

Penalty for Noncompliance With 90% Test

Absent reasonable cause, noncompliance with the 90% test gives rise to a penalty that is calculated by first calculating the shortfall of asset value below the 90% threshold on a monthly basis, and then multiplying such shortfall by the interest rate on IRS underpayments. Although the New Regulations do not provide any additional guidance regarding the calculation of this penalty or the circumstances in which the penalty might be avoided due to reasonable cause, the preamble to the regulations indicates that penalty considerations will be addressed within a few months. Furthermore, it is still not entirely clear if the statutory penalty will be the exclusive consequence of noncompliance with the 90% test.

Impact of New Regulations on Definition of QOZ Business

The New Regulations contain significant new rules regarding the QOZ Business requirement applicable to operating subsidiaries in which a QOF owns QOZ Stock or QOZ Partnership Interests, including the following:

50% of Gross Income of QOZ Business Within Zone

In order for an operating subsidiary to qualify as a QOZ Business, at least 50% of the subsidiary's gross income must be derived from the active conduct of a trade or business "within" a QOZ. Until the release of the New Regulations, there was no guidance regarding the meaning of the term "active conduct of a trade or business" or the manner in which the 50% test would be applied. As a result, there was concern that an operating business with significant revenues from customers outside the zone might not satisfy the 50% test (in contrast with rental real estate where there is no issue regarding the sourcing of revenue). The New Regulations provide three safe harbors for determining whether at least 50% of an operating subsidiary's gross income is derived "within" a QOZ. Under these tests, it will be possible for the subsidiary to satisfy the 50% test *even if most of its gross revenues are derived from customers outside the zone, whether from sales of products or licensing of intellectual property*.

The first two safe harbors are both based on the amount of services performed by employees and independent contractors of the subsidiary (and employees of such independent contractors). Specifically, under the first safe harbor, at least 50% of the services performed (based on *hours*) must be performed within the QOZ. Under the second safe harbor, at least 50% of the services performed (based on *compensation paid*) must be performed within the QOZ.

The third safe harbor is more subjective – providing that the 50% test is deemed satisfied if the tangible property located within the QOZ and the management or operational functions performed for the business within the QOZ are each necessary to enable the subsidiary to generate 50% of the gross income of the business.

Even if the subsidiary is unable to satisfy any of the safe harbors, it may still meet the 50% requirement based on a facts-and-circumstances test.

Active Conduct of Trade or Business

As noted above, a QOZ Business must derive at least 50% of its gross income from the "active conduct" of a "trade or business" within a QOZ. The term "trade or business" is defined in the New Regulations by reference to Section 162 of the Internal Revenue Code (regarding the rules for business deductions) – without provision of a specific definition for purposes of the QOZ rules – based on the Treasury's view that there is a large body of case law and administrative guidance interpreting the meaning of a trade or business under Section 162. The New Regulations contain a somewhat favorable provision under which the ownership and operation (including leasing) of real property is treated as satisfying the "active conduct of a trade or business" requirement for a QOZ Business, subject to the caveat that a mere triple net lease, without more, will not be eligible for such treatment. Except for this special real estate rule, the New Regulations do not contain any guidance regarding the meaning of "active conduct," although the Treasury has solicited comments from interested parties on this subject.

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Intangible Property Held by QOZ Business

Another QOZ Business requirement is that a "substantial portion" of the intangible property used by the operating subsidiary must be used in the active conduct of a trade or business. For this purpose, the New Regulations define "substantial portion" as 40%.

Working Capital Safe Harbor for Operating Subsidiary

The statute provides that liquid assets qualifying as "reasonable" working capital will not jeopardize the QOZ Business requirement that no more than 5% of an operating subsidiary's property may be attributable to "nonqualified financial property." The October 2018 regulations included a safe harbor under which cash and other working capital assets held by an operating subsidiary would be deemed "reasonable" for purposes of the 5% test. As originally proposed, working capital reserves would have been treated as "reasonable" under the safe harbor only if (i) the amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ, (ii) there is a written schedule providing that the working capital assets must be spent within 31 months, and (iii) the working capital assets are actually used in a manner that is substantially consistent with the foregoing written designations. In response to criticism, this safe harbor has been liberalized in three significant ways:

- First, the working capital may be used for the *development* of a trade or business in the QOZ (e.g., to fund operating costs of a startup business) as well as for the acquisition, construction, or improvement of tangible property.
- Second, the working capital does not need to be spent within the 31-month period if the delay is attributable to a wait for government action which had been applied for within the 31-month period.
- Third, a business may benefit from overlapping or sequential applications of the safe harbor (e.g., upon subsequent rounds of equity financing) – provided that each infusion of working capital independently meets the requirements of the safe harbor – even if it takes more than 31 months on a cumulative basis to spend the aggregate amount of working capital raised in multiple financing rounds.

"Substantially All"

The October 2018 regulations provided a 70% test for purposes of determining whether "substantially all" of the tangible property owned or leased by a QOZ Business constitutes QOZ Business Property. However, the Treasury intentionally did not provide any guidance at that time regarding the meaning of the words "substantially all" as they are used in other portions of the statute, instead soliciting comments on this question from interested parties. The New Regulations now provide that, for purposes of the requirement that "substantially all" of the use of QOZ Business Property must be in a QOZ during "substantially all" of the holding period in such property (whether in the hands of a QOF in a one-tier structure or an operating subsidiary in a two-tier structure), "substantially all" in the context of *use* of the property is 70% and "substantially all" in the context of *holding period* is 90%. Similar 90% requirements have been included in the definitions of QOZ Stock and QOZ Partnership Interests, as the case may be, such that the operating subsidiary in which a QOF holds QOZ Stock or a QOZ Partnership Interest must qualify as a QOZ Business for at least 90% of the QOF's holding period in such entity.

Valuation of Assets for Purposes of 70% Test

Consistent with the 90% test at the QOF level, the New Regulations liberalize the methodology for valuing tangible assets of an operating subsidiary for purposes of the 70% test by allowing the QOF to *choose* between the book values used on the subsidiary's applicable financial statements (if any) or unadjusted cost basis – rather than *requiring* the use of the subsidiary's applicable financial statements, as had been the case in the October 2018 regulations. Special rules for valuing leased assets are described below.

Real Property Straddling QOZ

For purposes of determining whether an operating subsidiary satisfies certain requirements of a QOZ Business, the New Regulations set forth circumstances in which real property located outside a QOZ would be taken into account. Specifically, (i) if an operating subsidiary uses real property located both within and outside a QOZ, (ii) the real property located outside the QOZ is contiguous to part or all of the real property located within the QOZ, and (iii) the amount of real property located within the QOZ is substantial compared with the amount located outside the QOZ (generally based on square footage), then the entire property would be deemed to be located within the QOZ for the limited purpose of applying those aspects of the QOZ Business requirements relating to the location of services, tangible property, or business functions.

Impact of New Regulations on Definition of QOZ Business Property

The New Regulations contain significant new rules regarding (i) the requirement that QOZ Business Property satisfy either an "original use" test or a "substantial improvement" test, and (ii) leases of tangible property, including the following:

Raw Land/Substantial Improvement

For property to qualify as QOZ Business Property, the statute provides, among other requirements, that either (i) the original use of the property in the QOZ must commence with a QOF or operating subsidiary, or (ii) the QOF or operating subsidiary must "substantially improve" the property (defined generally as incurring capital expenditures with respect to the property in an amount at least equal to the tax basis of the property at the beginning of any 30-month period after the QOF's acquisition of the property; i.e., effectively doubling the basis of the property within a 30-month period). The October 2018 guidance provided a favorable rule involving the purchase of an existing building on land within a QOZ, in which case the determination of whether the property has been substantially improved is measured by reference to the tax basis of the building, without regard to the tax basis of the land. However, no guidance was provided at that time regarding how to apply the substantial improvement test when a QOF or operating subsidiary constructs a new building on raw land. Under the New Regulations, subject to certain anti-abuse rules, there is no requirement for unimproved land to be substantially improved. However, the land will not qualify as QOZ Business Property unless (among other requirements) it is used in a trade or business within a QOZ (whether at the QOF level in a one-tier structure or at the operating subsidiary level in a two-tier structure). For this purpose, the mere holding of land for investment purposes will not give rise to a trade or business.

Original Use/Vacant Property

Under the New Regulations, the original use of tangible property generally commences on the date that the property is first placed in service in the QOZ for depreciation purposes. Thus, it is possible that used tangible personal property whose only prior use had been *outside* the QOZ could satisfy the original use test (thereby avoiding the need for the property to be substantially improved). In addition, it is possible that a QOF or operating subsidiary could be considered the original user of a built-to-suit real estate project (whether wholly or partially completed) if the project is purchased from a developer before any portion of the project has been placed in service. Furthermore, the New Regulations include a taxpayer-favorable rule under which property that has been unused or vacant for an uninterrupted period of at least five years may be eligible to satisfy the original use test.

Substantial Improvement of Multiple Properties

Under the New Regulations, the substantial improvement test is applied separately for each property acquired by a QOF or operating subsidiary – which may present computational concerns for the acquisition of a multibuilding project if only some (but not all) of the buildings will be improved. However, the IRS has requested comments from interested parties as to whether an aggregation rule would be appropriate.

Leased Property Generally

The New Regulations add significant new rules for (i) determining whether leased tangible property constitutes QOZ Business Property in the hands of a QOF or its operating subsidiary (in either case, in its capacity as a lessee) and (ii) valuing the leased property for purposes of the 90% test at the QOF level or the 70% test at the operating subsidiary level. Generally, in order for the leased property to be treated as QOZ Business Property: (x) it must be acquired under a lease entered into after December 31, 2017; (y) similar to tangible property that is owned, substantially all of the use of the leased property must be in a QOZ during substantially all of the period for which the property is leased by the lessee; and (z) the lease must be a "market rate lease" reflecting arm's-length market terms (determined under the tax law's Section 482 transfer pricing rules that apply in testing transactions between commonly controlled entities). There is no requirement for the leased property to satisfy an "original use" or "substantial improvement" test, as is the case for property that is owned.

Related Party Leases

The New Regulations make it clear that *leased* property does not fail to qualify as QOZ Business Property in the hand of the lessee merely because the lessor is a related party. In contrast, *owned* property that is acquired from a related party (based generally on a more-than-20% overlapping ownership test) does not qualify as QOZ Business Property. Although there is no outright prohibition against related-party leases, the New Regulations impose two additional requirements when the lessor and lessee are related parties. Specifically, property leased from a related party will not qualify as QOZ Business Property if, in connection with the lease, the lessee makes a prepayment to the lessor covering a period of use in excess of 12 months. In addition, solely with respect to tangible *personal* property, property leased from a related party will not qualify as QOZ Business Property unless (i) the original use of the property commences with the lessee, or (ii) within the period ending 30 months after the lessee's taking possession of property under the lease (or, if earlier, the last day of the lease), the lessee acquires tangible property qualifying as QOZ Business Property having a value at least equal to the value of the leased property and meeting certain other criteria.

Valuation of Leased Property

The New Regulations include special rules for determining the value of leased property in the hands of the lessee for purposes of both the numerator and the denominator of the 90% test at the QOF level and the 70% test at the operating subsidiary level. Generally, the lessee can choose between two approaches:

- If the lessee has "applicable financial statements" (under the same definition for purposes of the 90% test), the value of the leased asset shown on those financial statements may be used only if the statements are prepared in accordance with U.S. GAAP and require an assignment of value to the leased asset.
- Alternatively, the lessee may choose to value the leased asset based on the discounted present value of the rental obligations under the lease (including periods during which the lessee may extend the lease at a predefined rent), calculated at the inception of the lease, using a discount rate based on the tax law's concept of "applicable federal rate." For purposes of this alternative valuation approach, the discounted present value is used as the value of the leased asset for all future testing dates (i.e., it remains constant and is not subsequently recalculated).

Improvements to Leased Property

The New Regulations provide that improvements made by a lessee to leased property are treated as satisfying the original use requirement as "purchased" property to the extent of the unadjusted cost basis of the improvements. This confirms the seemingly obvious conclusion that a lessee's self-construction of a building on ground-leased land would be treated as property acquired by "purchase" that is potentially eligible as QOZ Business Property (assuming all other requirements are met), even though the building is not being purchased from a third-party seller.

Effective Date

The New Regulations will not be effective until they are published in final form in the Federal Register (which will probably not occur for several months). Taxpayers are generally permitted to rely on the New Regulations so long as they are applied in their entirety and in a consistent manner. However, taxpayers cannot rely on the proposed rules regarding the ten-year capital gain benefit until those rules are finalized.

Summary

The proposed regulations issued by the IRS on April 17, 2019 have provided much-needed clarification on many aspects of the QOZ rules. Although several questions still remain unanswered, it may be feasible for investors, developers, fund sponsors, and other affected parties to move forward with particular transactions. Due to the complexity of the QOZ rules, each situation will require a customized analysis based on multiple tax and non-tax factors. We would be happy to speak with you about the impact of the QOZ program in your particular situation. Questions about this Alert or the QOZ rules generally can be directed to Alan F. Kornstein, Curtis A. Johnson, Martin Dowd, and Jeffrey Petit.