NOVOGRADAC TAX CREDIT TUESDAY PODCAST

Summary: April 23, 2019

In this Special Opportunity Zones Edition of the Tax Credit Tuesday Podcast, Michael J. Novogradac, CPA, highlights key points from Treasury's second tranche of opportunity zones guidance. Categories include operating businesses, investors, fund operations, real estate and open items.

Summaries of each topic:

GENERAL NEWS

Operating Businesses

- First up, in the operating businesses category, let's look at the 50 percent gross income requirement outlined in the first tranche of opportunity zones guidance released in October.
- That first tranche of proposed regulations requires that at least 50 percent of the gross income of a qualified opportunity zones business be derived from the active conduct of a trade or business in the opportunity zone.
- Well, this second tranche of guidance details how to comply with the 50 percent requirement.
- More specifically, how to determine what extent your gross income is from an opportunity zone.
- The second tranche of guidance provides three safe harbors, as well as a facts-and-circumstances test.
- So here are the three safe harbors:
    - The first two safe harbors require that at least 50 percent of services be performed within the qualified opportunity zone.
    - One safe harbor measures services performed by hours.
    - The other safe harbor measures services performed by the amount paid.
    - Now the third safe harbor is that at least 50 percent of the gross income of a trade or business is generated by the tangible property and the management or operational functions performed for the business in the qualified opportunity zone.
- Now if taxpayers don't meet any one of these three safe harbor tests, then they may meet the 50 percent requirement if based on all the facts and circumstances, at least 50 percent of the gross income of a trade or business is derived from the active conduct of a trade or business in the qualified opportunity zone.
- Now another operating business topic addressed by the proposed regulations is that of leased property.
- Now that's a complicated topic, pretty involved and a lot more analysis is needed.
- But today, I'm going to talk about a couple of the points the guidance covers.
- And you can find much more analysis at the Novoco blog.
    - That's www.novoco.com/blog.
- Under the opportunity zones statute, opportunity business property must be "purchased."
- However, the substantially all test for qualified opportunity zone businesses refers to tangible property owned or leased.
- Well, the proposed regulations provide that:
    - Improvements made by a lessee to leased property satisfies the original use requirement and are considered purchased property.
    - They also say that leased tangible property may be treated as qualified opportunity zone business property for purposes of satisfying the 90 percent test at the qualified opportunity fund (QOF) level and the 70 percent substantially all requirement at the opportunity zone business level if:

    - Leased tangible property is acquired under a lease entered into after Dec. 31, 2017.
    - And the substantially all use of the leased tangible property is in a qualified opportunity zone during substantially all of the period for which the business leases the property.
- Now in addition, the regulations provide that leased tangible property may be valued using either an applicable financial statement valuation method that – would be basically GAAP or unadjusted cost basis – or an alternative valuation method, which is the present value of the leased payments.
- So those are the two methods or approaches to determining the value of the property for purposes of the 70 percent and 90 percent tests.
- I do note, however, in selecting this valuation method,that once a fund, or opportunity zone business selects one of the valuation methods for a taxable year, it must apply such method consistently to all leased tangible property valued with respect to that taxable year.
- Now again these are just some of the points related to lease property that were found in the second tranche.
- More analysis can be found online at www.novoco.com/blog.

Investors

- The next area I want to highlight falls into the category of guidance that has to do with issues of significance to investors.
- This guidance provides that investments in funds must be cash, or property, and notably does not include services.
    - Now for property contributions, the deferral election is limited to the tax basis of the property contributed.
    - In many ways, this is an anti-abuse provision, in that if you're able to elect to defer up to the value of the property, there's some anti-abuse that can occur.
    - Now the value received by an investor for the appreciated property or provision of services, the portion to which you can't make a deferral election, and when I mention provision of services, think carried interest, well that value of that interest that you can't make deferral election for is treated as property contributed for which an election is not made, and consequently the investor has a mixed funds investment.
    - Meaning a portion of the investment will be eligible for the opportunity zones incentive and a big portion of the investment will not.
- Now an additional note on the investor guidance front is a topic that I am writing about for Part II of my blog post series.
    - Specifically, the regulations provide that "an actual or deemed distribution of property (including cash) by a QOF partnership to a partner with respect to its qualifying investment is ***only an inclusion event*** if the distributed property has a fair market value ***in excess of the partner's basis*** in its qualifying investment."
- Now there's a lot packed into that sentence.
- I'll share more about it in the next blog post.
- It essentially would allow in many circumstances, partnership QOFs to distribute debt refinancing proceeds to its partners and not trigger acceleration of deferred gain.

- That said, please be aware, as I'll discuss in part two of the upcoming blog post, there are many traps for the unwary.

Fund Operations

- Now another major category of guidance in the proposed regulations falls under the headline of fund operations.
- Additional clarity has been provided on several points dealing with operating QOFs.
- For example, the proposed regulations provide QOFs six months to invest capital received from investors.
    - Now prior to this guidance, funds could have as little as one day to invest capital that was received from investors.
    - More specifically, the proposed regulations allow a QOF now to apply the test without taking into account any investments received in the preceding six months.
    - And when I say apply the test, I mean the 90 percent test.
    - Now the QOF's ability to do this is dependent on those new assets being held in cash, cash equivalents, or debt instruments with terms of 18 months or less.
- Now this provision means that a QOF will have at least six months to invest partner or shareholder capital contributions, and depending upon the timing of those capital contributions relative to the six-month testing periods, a QOF could have as much as nearly one year to make the investments of that cash contribution.
- Now another important issue that was addressed on the fund operation side was the time that QOFs had to reinvest proceeds from the sale or other disposition of qualified opportunity zone property.
    - This for purposes of satisfying the 90 percent test at the fund level.
    - More specifically, if qualified opportunity zone property is sold for cash, the property is no longer a qualified investment for purpose of the 90 percent test– but the opportunity zones statute allows a reasonable time to reinvest.
    - And the regulations now state that a "reasonable time," is 12 months.
    - So you have 12 months to reinvest those proceeds.
- And finally, in the fund operation category, I want to touch on the exit approach during the wind-down period.
    - The opportunity zones statute provides a fair-market-value step-up benefit only if a taxpayer sells its investment in a QOF.
    - Now selling an investment QOF runs a bit counter to the way funds are generally unwound, which is the fund sells assets and distributes them up to investors.
    - Well the proposed regulations provide a special election for certain sales of assets of a QOF partnership or QOF S corporation.
        - More specifically, a taxpayer that holds a qualifying QOF partnership interest or qualifying stock in a QOF S corporation may elect to exclude from gross income some or all of the capital gain from the disposition of qualified opportunity zone property by the qualified opportunity zone partnership or S Corporation that is reported on a Schedule K-1 for that entity, provided of course that this disposition occurs after the taxpayer's 10-year holding period of the stock or partnership interest.
        - Now what's particularly noteworthy here is that this only applies, if you read it technically, to the fund's sale of property.

        - If the fund has an interest in a business, and that business sells property, the gain of which flows through the fund to the investor, this election may not apply.
        - We'll need to get more guidance from the IRS on this point.
        - It's also important to note that the Treasury Department and the IRS do intend to implement targeted anti-abuse provisions with respect to this election.

Real Estate

- Next, let's consider a few of the points the guidance addresses related to real estate concerns.
- First, there are two points related to original use:
    - Under the proposed regulations, "original use" of tangible property commences on the placed in service date for purposes of depreciation or amortization.
        - This is a good clarification dealing with original use for acquisitions of property under construction.
    - And on a related note, the proposed regulations provide that a property's history of prior use will be disregarded if the property has been vacant for at least five years.
    - Many had asked for this provision.
    - Many, including the Opportunity Zones Working Group, had suggested a one-year timeframe, but the IRS ultimately settled on five years.
- Now another point of clarity provided on the real estate front is that the second tranche makes clear that business may benefit from multiple overlapping or sequential applications of the 31-month working capital safe harbor.
    - We thought that was the answer.
    - The regulations clarified that.
- And in the real estate area, guidance was needed whether renting property pursuant to a triple-net lease can be an active trade or business, and we also wanted final confirmation that operating residential rental property is an active trade or business.
    - Well the proposed regulations provide 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.
    - But I should note, the regulations do provide that merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer.
- Now it's unclear to what extent a triple-net lease could be operated at an opportunity fund level, since at that level there is no technical active trade or business requirement, or if it's only for indirect investments through opportunity zone businesses for which this triple-net lease ban, if you will, applies.
    - We'll need more guidance from the IRS on that.
    - We'll also have to have more guidance as to what constitutes a triple-net lease versus what level activity short of a triple-net lease is sufficient to be the active contact of a trade or business.
- Now again, just as a reminder, these are just a few examples of the guidance that we're analyzing.

- Several additional real estate considerations are addressed in the second tranche and mentioned in the blog post.

Open Items

- Finally, let's turn to open items.
- As noted earlier, even though the proposed guidance is 169 pages long, there are still questions that remain unanswered.
- For one, there's still the question of interim gains at the fund level.
    - Treasury asked in the first tranche of guidance whether interim gains should be subject to tax.
    - Treasury said it was concerned that it may not have the regulatory authority to decide that those gains are not subject to current taxation.
    - Obviously, that's a big question that investors in opportunity funds will need to consider and would like answered.
- Now another item that remains open is the matter of reporting requirements.
    - This dealing with impact and additional data not for tax compliance, but for evaluation of the incentive.
    - Treasury did not impose reporting requirements in this second tranche of guidance.
    - But, Treasury has released a request for information that asks for public input on how to best measure economic activity in opportunity zones and how to collect this information.
    - Now I've mentioned in recent podcast episodes a bipartisan push from legislators for Treasury to create reporting requirements.
    - The goal is to create transparency and accountability in the opportunity zones incentive and to collect information on how well the incentive achieves its intended purpose to drive investment into distressed communities.

RELATED RESOURCES

Investing in Qualified Opportunity Funds (guidance)

Clarity Provided by Second Tranche of Treasury Regulations to Incent More Investment in Opportunity Zones Businesses (Part I), Notes from Novogradac

Novogradac 2019 Opportunity Zones Spring Conference, April 25-26

Novogradac Opportunity Zones Regulations Webinar, May 14