OPPORTUNITY ZONE IRS GUIDANCE: ROUND TWO

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On April 17, 2019, the IRS released a second round of guidance (Round Two Guidance) with respect to Qualified Opportunity Zones (QOZs) through an additional 169 pages of proposed regulations, and an update to its FAQ list, along with a request for information on data collection and tracking for QOZs. The new guidance goes a long way to clarifying and revising many aspects of this topic in an effort to spur investments but there are many sections where the IRS requested additional comments that might be further helpful at some future point.

The following is not an exhaustive review but highlights topics that have been discussed in connection with structuring and implementation of QOZ investments. In addition to the future release of the two sets of proposed guidance in final form, a third set of guidance is also expected to be issued later this year to address Qualified Opportunity Fund's (QOF) reporting and revisions to IRS Form 8996 filed with the election of QOF status and annual filings thereafter.

The following does not repeat points listed in the first set of IRS guidance and discussed in our summary dated October 21, 2018. Where used, the first set of proposed guidance is referenced as the 2018 proposed regulations.

Effective Date: Round Two Guidance is effective when issued in final form, but the guidance can also be applied and relied on by taxpayers prior thereto on some points, but only if the eligible taxpayer applies these rules in their entirety and in a consistent manner. Query how that statement will actually be applied in any situation where one provision of the guidance is not applied by a taxpayer and the IRS is open to receiving further comments on the point.

1. Extension of 180-Day Period to Invest Certain Capital Gains (Section 1231 Gains).

Round Two Guidance provides an extended period for Section 1231 capital gains, but limits the amount available for investment.

First, only the net Section 1231 capital gain amount (the excess of the net of the Section 1231 capital gain over the Section 1231 capital losses) is the amount that can be invested in a QOZ. This means that if the Section 1231 capital gains exceed the Section 1231 capital losses for the applicable year, only the net amount is available for QOZ investment, and not the gross Section 1231 capital gain amount for such tax year. This net amount can only be calculated at the end of the tax year after all sales have occurred. This limitation applies only with respect to Section 1231 capital gains. Capital gains that are not considered Section 1231 capital gains (such as sales of stock or sale of land held for investment and not used in a business) are not subject to this net limitation.

Second, the net Section 1231 capital gain amount can be invested in a QOF during the 180-day period commencing on the last day of such person's tax year. Accordingly, the net Section 1231 capital gain that arises from a sale during February of one year is eligible for QOZ investment through late June of the following year. Again, capital gains that are not considered Section 1231 capital gains (sales of stock or sale of land held for investment and not used in a business) are not eligible for this extended 180-day investment period.

What is Section 1231 capital gain? In general, Section 1231 gain is related to the sale of any depreciable property (other than recapture ordinary income) and from real property held at least one year and used in a business (not dealer or solely investment property).

With respect to unimproved land held only for investment, such property is not Section 1231 property, but it would still give rise to capital gain and not netted against any capital losses. In such case, the 180-day clock begins on the closing date assuming the full purchase price is paid at closing. There can be a question as to whether land was acquired for investment or is considered used in a business, which would trigger when the 180-day period begins and whether a Section 1231 netting must be applied.

Effects:

a. 2018 net Section 1231 capital gains for a calendar tax year can be invested in a QOF through late June 2019. For persons who have already filed a 2018 federal income tax return, an amended tax return must be filed, and consideration needs to be given to making the QOZ deferral election for 2018 or 2019, or both.

b. 2019 net Section 1231 capital gains for a tax year can be invested in a QOF through late June 2020.

c. If you have Section 1231 capital gain for a year and expect to have Section 1231 net capital gain for the full year and plan to make a QOF investment during such year, rather than during the 180-day period following such year, consideration should be given to the appropriate structuring so that these capital gain dollars are not properly invested until the subsequent year.

d. The combination of the additional period provided with respect to net Section 1231 capital gain that extends the 180 days to invest in a QOF plus the additional time (discussed in (2) below) to allow the QOF to invest in a second-tier entity in satisfaction of the QOF 90% test, when added to the 31-month safe harbor period for the second-tier entity to apply the cash dollars extends the aggregate period to complete the project and spend all of the applicable cash.

Observation: The 2018 proposed regulations provided an extended period to the equity member of a pass-through entity (i.e., LLC, partnership, S corporation) when capital gain is recognized by such entity and such entity does not make a QOF investment for part or all of the capital gain amount. In such case, the equity member's 180-day period to invest the flow through capital gain amount into a QOF begins on the last day of the pass-through entity's tax year.

In a similar manner, it would seem that an equity member of a pass-through entity can invest the capital gain amount shown on the K-1 received, which would be the net Section 1231 capital gain, the net long-term capital gain, and the net short-term capital gain, during the 180-day period of the following year.

2. Time for QOF to Meet the 90% Requirement—Revised but Limited Effect.

Under the 2018 proposed regulations, for investments into a QOF during the second half of a calendar year, the QOF must have met the required 90% test by December 31. Round Two Guidance softens this requirement to allow for any contribution during the second half of the year to be ignored in calculating the QOF's 90% test as of December 31. In such instance, the effect is that the 90% test would not have to first be met until June 30 of the following year, with respect to contributions made during the second half of the calendar year.

For capital gains where the 180-day period ends in the second half of the QOF calendar year and cash is contributed to the QOF at that time, the Round Two Guidance permits an additional 6-month period to invest the capital gain proceeds. However, this time period is shorter than had been hoped. Further, the 31-month safe harbor to allow cash to be held does not extend the required time for the QOF to satisfy the 90% test.

Effect: The limited period for QOFs to invest capital gain dollars will continue to have QOFs make investments through a second-tier operating entity to utilize the 31-month period to spend the cash received. The additional period for QOFs to transfer cash investments into a second-tier operating entity buys additional time to start the 31-month clock for the operating entity to apply the cash proceeds.

This additional time is also applicable to not take into account contributions received during the first half of the QOF tax year from the first 90% testing date at the first six-month mark, and only take such contributions into account on the December 31 testing date. In this situation, the extension will be less than six months.

3. Level of Detail Required with Respect to Spending Cash within the 31-Month Safe Harbor Following Receipt of Cash by the Operating Entity.

The 2018 proposed regulations require a written schedule consistent with the ordinary start-up of a business detailing how cash will be spent towards permitted purposes. The prior regulations illustrating the necessary written schedule seem to require detailed information regarding the specific land to be purchased and the amount to be spent toward the building.

Round Two Guidance seems more flexible with respect to the written schedule needed and to applying the cash amount substantially consistent with such written schedule. A new example allows cash to be allocated for the identification of a favorable location to lease a building, and an amount to outfit the building with appropriate equipment and furniture. This example seems helpful to allocating an approximate amount towards the purchase or construction of a building, even though the specific location is not known at the beginning of the 31-month period.

Also, Round Two Guidance provides that the 31-month period is extended if the cash cannot be spent consistent with the scheduled detail during such period due to a delay stemming from waiting for governmental action on a completed application. It is not clear whether all of the time following the submission of an application is tacked on to the 31-month period or whether the delay is taken into account only when it can be shown that the project is immediately ready to spend such cash amount during the 31-month period but for the required government action and there is no opportunity to accelerate the spending of the cash amount once the government action is obtained within the 31-month period. If the government approval of a completed application is not issued until after the 31-month period, then some form of extension should occur. A related question would be whether any delay by the operating entity to submit the application must also be taken into account.

4. Use of Capital Gain Dollars Toward Start-Up Tech Companies. Expansion of 31-Month Safe Harbor Beyond the Acquisition, Construction, and/or Substantial Improvement of Tangible Property to Development of a Business.

Our firm submitted a November 2, 2018 comment letter to the IRS requesting an expansion of the guidance to allow for capital gain dollars to be used toward the expansion of a technology company's operations (e.g., salaries for research) over the 31-month safe harbor period, allow for the receipt of revenue from licensing outside the OZ, the favorable treatment of leased property, and treating the 31 month start- up phase as satisfying active business requirement. Round Two Guidance is favorable on these points.

Round Two Guidance allows the 31-month safe harbor to be used multiple times with respect to capital gain contributions to the QOZ that are invested in a second-tier operating entity.

The specific application of the OZ provisions in the context of investing in operating companies will be covered separately.

5. Real Property Straddling the QOZ can be treated as QOZ Property for Certain Purposes.

For certain purposes, real property contiguous to QOZ real property that is insubstantial in amount (based on square footage) is also considered to be located within the QOZ. Further consideration needs to be given to whether this point also applies to allow such contiguous property to be treated as qualifying business property for purposes of the 70% test.

6. Sale of Operating Assets and Reinvestment of Cash Proceeds within 12 months Does Not Impact the 90% QOF Requirement, But Triggers Gain.

If a QOF sells OZ property and reinvests the sale proceeds within 12 months in additional qualified OZ property, the cash proceeds would not negatively impact the QOF's ability to satisfy the test that 90% of its assets be qualified OZ property. Accordingly, the fact that the QOF holds cash for 12 months would not impact the investors' holding period in the QOF nor trigger the deferred gain.

Two additional considerations stem from a sale of the operating assets:

a. Non-Application to Second-Tier Operating Entity. Round Two Guidance acknowledges that this special rule is applicable to transactions by a QOF and not, as drafted, to the sale of the operating assets by a second tier entity. Comments are requested on whether an analogous rule should be applied to sales by a second-tier operating entity. The effect of the sale by a second-tier operating entity owned by the QOF would seem to be that the cash amount exceeds the 5% nonqualified financial property limitation and having cash for the extended period would impact the QOZ business property requirement. If this is to be viable relief in the context where assets are sold within the 10-year period, the relief needs to be extended to the sale by the second-tier operating entity.

One situation where it might be possible for the second-tier operating entity to sell assets and reinvest the proceeds within 12 months would be for the operating entity to immediately distribute the cash to the QOF and then for the QOF to reinvest the cash during the 12-month permitted period through the second-tier entity. The exception to the QOF 90% requirement is applicable to “return of capital” by the QOF. The receipt of the sale proceeds from the second-tier operating entity would seem to be a “return of capital.”

b. Gain From Sale is Not Avoided. Gain resulting from a sale of property within the 10-year holding period by the QOF (or the second-tier operating entity) must be recognized, even though the proceeds are reinvested within the 12-month period in qualifying property. The IRS states that it does not have the authority to exclude such gains, and requests comments. Additional appreciation after such reinvestment is available for tax free status if the 10-year holding period is met.

Many QOFs and operating entities will hold the initial assets for the full 10-year plus period. However, economic conditions might support the sale of assets earlier and this can arise more regularly with respect to investments in start-up companies.

The requirement under Round Two Guidance that the gain from the QOF sale of an interest has the following effect in a partnership/LLC situation. The gain recognized by the QOF flows through to the QOF investor and dilutes the tax benefit of tax-free appreciation from the initial investment date. The deferred gain relating to the initial capital gain investment would remain unaffected. The QOF has a new cost tax basis in the reinvested proceeds and consideration would need to be given whether such reinvestment is eligible for accelerated depreciation.

7. Purchase of Qualifying Equity Interest in a QOF from an Investor can be a Qualifying Equity Interest to the Purchaser, but Tax Benefits Available are Unclear.

Round Two Guidance states that the purchaser of an outstanding qualifying interest in a QOF would also be making a qualifying investment. The amount of the qualifying investment is determined by the cash and the property value paid for such interest.

Further consideration needs to be given to what tax benefits, if any, are available to the purchaser of an outstanding qualifying interest in a QOF.

a. There is no reference that the purchaser of the qualifying interest must have capital gains recognized within 180 days preceding the purchase.

b. Consistent with other portions of the Second Round Guidance, the transfer of appreciated property in exchange for a qualifying investment in a QOF and the resulting gain on such transfer is not eligible for the deferral and partial exclusion benefit.

c. If there is no capital gain preceding the purchaser's investment in the qualifying interest that is eligible for deferred gain status and a related election, it does not seem that the tax-free appreciation benefit would be available to the purchaser. Both sets of the proposed IRS guidance state that the tax free appreciation is available only for the portion of the investment for which a proper election to defer gain is in effect. If there has not been any initial capital gain deferral election made, then the tax-free appreciation benefit is unavailable.

d. Whatever benefit is available through the provision in the Round Two Guidance would seem unavailable to a purchaser of an interest in a pass-through entity that owns a QOF qualifying interest. The new provision requires that the eligible interest be acquired, which would not be the case in the instance where an interest in a pass-through entity that owns the QOF interest is acquired.

8. Holder/Seller of Interest in QOF Can Sell QOF Interest and Reinvestment of Recognized Gain Restarts the Required Holding Period with Respect to Second QOF Interest Purchased. The 2018 proposed regulations state that a holder of a QOF qualifying interest can sell such interest and reinvest the resulting capital gain amount (which would include the capital gain deferral amount) in a QOF. Round Two Guidance confirms the additional point that the seller of a QOF qualifying interest who makes a reinvestment in a second qualifying QOF interest restarts the holding period relating to the amount of deferred gain that can be excluded and the 10-year holding period for future tax-free appreciation.

9. Contribution of Appreciated Property to a QOF in Exchange for an Interest. Round Two Guidance permits property (other than cash) to be contributed in exchange for a QOF interest but with different results depending on whether (a) capital gain was recognized by the investor from an unrelated sale within the 180-day period, (b) appreciated property is contributed, and (c) gain is triggered on the contribution of the property to the QOF.

If consideration is given to contributing appreciated property to a QOF, caution must be exercised as it may result in a mixed investment and should be carefully matched with the desired amount of capital gain deferral.

10. Confirmation that Tax Basis of QOF Interest is Increased By Financing at LLC Levels.

In an LLC/partnership context, debt financing permits leveraged-based distributions, provided they are not sufficiently close in time to be treated as a disguised cash distribution.

11. Confirmation that Satisfying 10-Year Holding Period of QOF Interest Avoids Recapture Income from Accelerated Depreciation at Operating Entity that Flowed through to Investors.

However, as discussed below, this same result does not seem to occur when the QOF sells partnership assets.

12. Confirmation that at 5-Year and 7-Year Holding Period when 10% and 15% Step Up in Tax Basis occurs, Suspended Losses, if any, Can be Absorbed by QOZ Investor at that Time.

13. Extensive Rules Regarding Transfers of QOF Interests that Trigger Deferred Gain, and exceptions with respect to certain restructuring of the QOF or the Second-Tier Operating Entity.

Transfer of a QOF interest at death is not a triggering event, and the beneficiary steps into the shoes of the former holder.

Transfer of a QOF through a gift is a triggering event, even if the transfer is a charitable contribution to a tax-exempt entity. Accordingly, the approach of incurring deferred gain and then making a charitable contribution based on the value of the interest without triggering the deferred capital gain was rejected.

Transfer of an interest in an LLC/Partnership that owns a QOF interest is a triggering event.

Transfer of an interest in an S corporation that owns a QOF interest is a triggering event only if there is a more than 25% change in ownership interests.

Claiming a worthlessness deduction for the investment in the QOF is a triggering event. If the investment is worthless, then the deferred gain would not be recognized because there is a cap on the deferred gain based on the value of the QOF interest on the disposition date. Consideration would need to be given to whether and when a worthlessness deduction can be claimed for the QOF interest because the tax basis of such interest is originally zero.

On a triggering event, the deferred gain is taken into account to increase tax basis of the QOF interest before calculating the gain from the actual transfer event.

14. Guidance Does Not Permit Capital Gain Recognized by Individual To Be Invested in a QOF Through his Wholly-Owned Corporation or Partially-Owned Partnership/LLC.

Similarly, a corporate member of a federal income tax consolidated group that recognizes the capital gain can make an investment in the QOF but the tax benefits would not be available if another member of the consolidated group (who does not have recognized capital gain) makes the investment in the QOF.

Effect: Individual that owns a business that plans to expand within an OZ must establish a separate QOF and execute a leasing arrangement with his existing business.

15. Benefit of Tax-Free Appreciation After 10 Years of Holding QOF Interest Available through Sale of QOZ Interest and Sale of QOF Assets, but Limitations Might Apply.

The OZ statute requires for the sale of an interest in the QOF to obtain the benefit of tax-free appreciation after 10 years. Round Two Guidance expands the availability of the tax-free appreciation to allow for the sale of assets by a pass-through QOF entity (LLC/Partnership/ S corp), rather than only through the sale of the interest in the QOF. Mechanically, the new guidance provides that the sale of QOF assets does not trigger gain at the partnership level, but that the realized gain amount nonetheless increases the investor's tax basis in his QOF interest. The increased tax basis allows for the sale proceeds to be distributed tax free to the QOF investor.

The 2018 proposed regulations raised for possible future consideration of whether the step up in tax basis can occur in 2047 without the need for an actual sale of either the QOF assets or QOF interest. This question remains open and the IRS has requested comments on the point.

Specific details:

a. Round Two Guidance states that the sale of assets to achieve tax free-appreciation for the QOF investor applies only with respect to a sale of assets by a QOF pass-through entity. As stated, this benefit can apply if the QOF holds operating assets directly (not likely) or if the QOF sells its interest in a second-tier operating entity. However, the benefit might not be available in the common situation where the QOF owns an interest in a second-tier pass-through operating entity and such entity sells its assets. This rule might be adjusted in response to future comments because there is no justification to limit its application to the QOF. Further, the exclusion of income at the QOF level might equally apply to exclude the gain recognized at the second-tier operating entity level, and this will be determined with time.

b. The exclusion of gain at the QOF level is limited to the capital gain reported on the Schedule K-1 issued by the QOF pass-through entity. The capital gain shown on the Schedule K-1 are the separate categories of net Section 1231 capital gain, net long term capital gain, and net short term capital gain.

While further consideration should be given to confirm the point, at first blush the net result seems to be the same even though the sale of the interest in a QOF pass-through entity does not need to break down the capital gain components associated with such sale as would a sale of the QOF assets.

An obstacle to the symmetry that the same tax result should arise whether the QOF interest or the QOF assets is sold after the 10-year holding period is that the new guidance permits the gain exclusion at the QOF level only for capital gain and not ordinary income (recapture income). This seems inconsistent with the result that all gain (including gain recharacterized as ordinary income and stemming from bonus depreciation) escapes taxation on the sale of a OZ interest after the 10-year holding period. An example in the new guidance provides an opportunity to clarify this point but does not.

c. The tax basis step-up associated with a 10-year holding period is also available for QOF partnership assets that would generate ordinary income, such as inventory and unrealized receivables (depreciation recapture). This goes to the point that bonus depreciation is not recaptured when the income flows through on a sale of the assets after a 10-year holding period.

d. If the QOF is a C corporation, the sale of QOF assets would generate gain that is captured and taxed at such entity level and the distribution of the sale proceeds would be tax free. However, there would be gain taxed in such instance, whereas none of the future appreciation would be recognized in the context of a QOF that is a pass-through entity. If the QOF is established as a C corporation, the most efficient exit strategy is the sale of the stock in the QOF.

If the OZ investor is a corporation, Second Round Guidance denies treating the QOF as a C corporation member of the federal income tax consolidated group that would allow for pass-through treatment.

e. The effective date with respect to this provision only states that it is effective for tax years ending after the Second Round Guidance is issued in final form. This effective date does not contain the added text that such guidance can be relied on currently. These exit steps will be down the road, well after the guidance is issued in final form.

<u>Effect:</u> Until this clarification was issued, some arrangements were structured using separate QOF pass-through entities for each project, even with identical overlapping investors. The new guidance would seem to allow the use of one QOF pass-through entity having ownership interests in multiple investments, with the exit strategy being the separate sale of the interest in each second-tier operating entity, but questions remain.

<u>16. Tax Basis of Assets Acquired by the QOF or the Second-Tier Operating Entity with Invested Capital Gain Proceeds is Cost.</u>

Round Two Guidance clarifies that the tax basis of the assets purchased by the QOF or the second-tier operating entity is its cost. This issue arose because the investor has a zero tax basis in its investment in the QOF and the concern has been that such zero tax basis might track its way to the acquired assets. Not so. The cost basis at the operating entity allows for bonus depreciation to be claimed and to flow through to the QOF investor.

Further, when there is an automatic adjustment in the tax basis of the QOF interest at the 5-year and 7-year holding period points and when the remaining deferred gain is recognized in 2026, no further adjustment to the tax basis of the QOF assets or the second-tier operating entity is made.

<u>17. Required Notifications Relating to and by Pass-Through Entities.</u>

a. If a pass-through entity contributes capital gain dollars to a QOF, such pass-through entity must notify the members of their allocable share of the deferred gain.

b. If a member of a pass-through entity to whom capital gain flow makes a contribution to a QOF, such member must notify the pass-through entity of the eligible gain deferred. Query why this is needed.

c. If a member of a pass-through entity that is an investor in a QOF transfers its interest prior to 2026, such member must notify the pass-through entity to allow such entity to recognize the deferred gain.

d. If a member of a pass-through entity that is an investor in a QOF transfers its interest after the required 10-year holding period, such member must notify the pass-through entity to allow such entity to adjust the tax basis of such transferred interest.

18. Active Conduct of a Business.

A basic requirement is that 50% of the operating entity's gross income must come from the "active conduct of a business." Round Two Guidance references a specific Internal Revenue Code provision (Section 162) to determine what is a business but provides limited additional guidance to the question of what is the active conduct of a business and what is needed for leasing to be treated as the active conduct of a business. While the guidance states that ownership and operation (including leasing) of real property is the active conduct of a business, the guidance goes on to state that merely entering a triple-net-lease with respect to the real property owned by a taxpayer is not the active conduct of a business. There has been a lot of debate as to what level of operation is needed to avoid disqualified status, but some level of additional operation is needed.

Based on the level of debate, my speculation and hope is that a safe harbor will eventually be issued for leasing arrangements. In the meanwhile, it would be safe to increase the lessor's operation through the lease terms and address such additional expenses through the rent.

19. "Substantially All" of the Use of the Qualifying QOZ Tangible Business Property Must be in a OZ, Which is Defined as at Least 70% of Such Use.

In real estate arrangements as with most single focused project, this should be easy to meet with respect to all of the tangible property owned or leased by the operating entity.

Inventory (including raw materials) that either are in transit (a) from the vendor to business in an OZ or (b) from a facility within an OZ to customers outside the OZ are counted as used in an OZ. Consideration is being given to where inventory (including raw materials) are stored should be taken into account.

20. Certain Requirements Must Be Met During "Substantially All" of the Holding Period, Which is Defined as at least 90%.

21. "Substantially Portion" of Intangible Property is Used in Active Conduct of a Business, Which is Defined as at Least 40%.

While the new guidance could been clearer, start up tech companies that utilize technology regularly should be treated as using such intangibles in its home office located within a OZ and not where the customers are located. Consideration should also be given to employees who work primarily from their homes located outside of a OZ.

<u>22 ORIGINAL USE REQUIREMENT: Tangible Property Can Be Treated as Original Use in an OZ when the QOF or Second-Tier Operating Entity Purchases Property and Such Entity Places the Property in Service for Depreciation Purposes.</u>

Tangible property that is treated as “original use” is eligible property for purposes of the requirement that substantially all (70%) of the tangible property be qualifying business property, without the need for such property to be substantially improved. Tangible property that is not treated as “original use” property must be substantially improved to qualify for purposes of the 70% requirement for all tangible property.

<u>Examples:</u>

a. Acquired equipment that was previously used outside an OZ qualifies as original use.

b. Acquired equipment that was previously used within an OZ does not qualify as original use and must be substantially improved to be included in the numerator for purposes of the 70% requirement.

c. Acquired equipment that was owned by another person within an OZ, but never placed in service for depreciation by such other person qualifies as original use.

d. Acquired building and raw materials that is a work-in-progress qualifies as original use if such materials have not been placed in service for depreciation.

e. Building that is constructed for resale qualifies as original use because first depreciated by purchaser.

f. Building constructed on leased land is treated as purchased and qualifies as original use.

g. Building vacant for at least five years qualifies as original use. Question is how to administer and enforce such a rule.

h. Improvements made by lessee on leased property are treated purchased and qualify as original use.

<u>23. SUBSTANTIAL IMPROVEMENT REQUIREMENT: Purchase of Land and Building Followed by “Substantial Improvement” to Building Allows Land to also be Treated as Substantially Improved and Included in the 70% Qualifying Tangible Property Requirement.</u>

Additional Substantial Improvement Points:

a. Substantial Improvement is required on an asset-by-asset basis, with exception for building acquired with land.

For purposes of applying substantially improvement test, IRS is considering whether to allow aggregating properties in same location and of the same depreciation class (possibly including the purchase of multiple buildings), whether equipment that is nearly new but previously used can be taken into account, and whether purchasing original use property can be included to satisfy the substantial improvement requirement.

b. When land and building are both acquired, substantial improvement to the purchased tangible property is measured by additions to the building. This seems to allow equipment purchased as part of a building and segregated pursuant to a cost study to also be treated as substantially improved if the renovations allocated to the building alone satisfy the double down test, even though no improvements are made to the equipment. To implement this rule, it would seem that when purchasing land and building, a cost segregation should be made among the land, building, and equipment. Only the improvements to the building are taken into account to assure that the double down rule is met, and improvements to the equipment and the land are not.

c. With respect to contributions made to an existing operating business, the amount of currently owned tangible property is included in the denominator and a sufficient amount of original use or substantial improvements are needed to additional purchased tangible property to reach the 70% threshold. Substantial improvements to the currently owned tangible property are not useful because such property was not purchased by the entity after 2017. Consideration needs to be given to a restructuring in such instance. However, in many start-up entities, the currently owned tangible property might be relatively small.

24. Leased Property: Special Rules.

Leased tangible property available pursuant to a lease that (a) is entered after December 31, 2017 (and possession obtained after such date), (b) is substantially used in a OZ during substantially all of the full lease period, and (c) has all lease terms at market as of the time the lease was entered is treated as qualifying business property for purposes of the requirement that substantially all (70%) of the tangible property be qualifying business property, without the need to determine whether the leased tangible property is original use or substantially improved and without the requirement that the leased property be purchased. Consideration is being given to whether a safe harbor presumption can be developed to assure market rate lease terms. These requirements apply to leased real and personal property.

This is a very favorable rule that allows leased tangible property to automatically be eligible as qualifying business property. An anti-abuse rule is added to assure that the arrangement is a true lease with respect to a leased building. There cannot be an expectation, intent, or plan for such real property to be acquired at a price below market value at the time of purchase.

Leased tangible property (real and personal property) that is leased from a related person is also qualifying business property provided that there cannot be a prepayment pursuant to the lease that exceeds 12 months.

For leased personal property from a related person that has already been in use in the OZ, there is the additional requirement that the lessee acquire additional tangible property that is greater than the value of the leased personal property during the 30-month period starting with when the lessee receives possession under the lease. For this purpose, the leased personal property and the acquired additional tangible property must be in the same OZ. Also, for this purpose, the valuation discussed below can be used to determine the value of the leased personal property that needs to be exceeded. Leased personal property with a related person that has not been used in an OZ and then is transferred to be used within the OZ is qualifying business property for purposes of the 70% test, without regard to this additional requirement. This additional requirement is not applicable to leased real property from a related person.

Improvements made by a lessee to leased property are treated as original use property and as purchased at the cost of the improvements for purposes of applying the 70% substantially all requirement.

These rules allow leased real property and leased equipment pursuant to a post-2017 lease to automatically qualify as OZ business property toward the substantially all 70% requirement. In the context of a start-up business that primarily rents space and might rent equipment, this goes a long way to not having to make improvements or acquire property that would need to be treated as qualifying business property.

If a business leases tangible property pursuant to a lease entered on or before December 31, 2017, then the value of the property pursuant to such lease must be taken into account for determining the amount of additional tangible property that needs to be acquired, substantially improved, or leased.

Favorable rules were issued for leased property on the premise that such arrangement would spur increased business activity and economic investment within OZs. This fits well with the application of capital gain dollars through a QOF towards an operating businesses.

25. Building Needs Substantial Improvements and Its Owners Have Eligible Capital Gain.

Consideration needs to be given to current business owners who have been in an OZ and operate from a building that needs substantial improvements. Assume the business owners have capital gain dollars that can be used toward the improvements. The business owners may not want to have unrelated persons own an interest in the building or the business, and they have the capital gains to implement a QOF structure.

The favorable leasing provisions could provide an avenue to structuring an arrangement that maintains the current ownership. Second Round Guidance also raises studying whether additional guidance is needed where tangible property that has not been "purchased" but has been overwhelmingly improved may satisfy the original use requirement. We had a comment letter drafted on this point but waited for Second Round Guidance to be issued to understand its potential application.

26. Valuation of Leased Property for Requirement that Substantially All (70%) of Tangible Property Must be Qualifying OZ Business Property.

Leased tangible property used by an operating entity in a QOF structure must be valued for purposes of the requirement that 70% of the tangible property must be qualifying OZ business property. The valuation of the leased tangible property is needed to be (a) taken into account through a post-2017 lease that is treated favorably under Round Two Guidance or (b) taken into account through a pre-2018 lease or a post-2017 lease that does not meet all requirement for favorable treatment in the 70% substantially all calculation.

The leased tangible property can be valued under the GAAP method if such method is used by the operating entity on its financial statement or based on the present value of the of the lease payments discounted at the applicable federal rate. The use of the GAAP method is an annual determination, whereas the alternative valuation approach is determined only when the lease is entered. In similar fashion, the alternative method used for purchased property is the unadjusted cost basis for purposes of the 70% qualifying OZ business property calculation.

For purposes of determining the valuation of leased tangible property, the lease term includes periods that the lessee can extend the term at a pre-defined rent. The longer the lease term, the higher the present value amount but the later years have a limited impact. Depending on whether the leased property is counted favorably or unfavorably in the 70% calculation, consideration can be given to the possibly limiting the lease term, unless nonsensical for business reasons.

27. Anti-Abuse Rules.

The Second Round Guidance provides general rules to deny tax benefits where a significant purpose of the transaction is to achieve results inconsistent with the purposes of the provisions.

With respect to the favorable rules for leased property, buildings leased pursuant to a post-2017 lease are not qualifying business property where there is an expectation, intent, or plan for such real property to be acquired at a price below market value at the time of purchase. It could be that a similar rule will be applied leased personal property.

With respect to unimproved (or minimally improved) land acquired by an operating entity, such land cannot be taken into account as qualifying business property if the land is purchased with an expectation, intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the purchase.

28. What’s Next?

a. The 2018 proposed regulations will be revised and issued in final form.

b. Comments will be submitted and a hearing will be held on the Round Two Guidance to be followed by the issuance of such regulations in final form.

c. Revised IRS Form 8996 could be reissued with respect to make a QOF election for 2019 and future years. The form will request additional information regarding (i) the qualified OZ business to be owned by the QOF or its second-tier operating subsidiary and (ii) the amount invested in particular census tracts. The form might also include the reporting of owned and leased tangible property and the employees of a OZ business.

d. Round Three Guidance is expected to address the OZ data to be collected. IRS has requested comments regarding additional data gathering that should be required, including, (i) measures signaling improved economic development, (ii) measures of job creation, (iii) who would collect the date, (iv) frequency of data collection, and (v) sources from which to collect data. There is also discussion of whether to gather information on the investment level absent the OZ tax provisions.

e. Two possible legislative bills to be introduced but whether passage will occur is uncertain: (i) data gathering with respect to OZ investments and (ii) extending the benefit for the 15% exclusion of the deferred gain for 2020 investments in a QOF.

f. Pursuant to an Presidential Executive Order, a report is to be issued by 13 federal agencies in December 2019 to assist distressed areas, including OZs.

For more information, please contact Frank Ferrante, Alexis Kim, or any of the firm's Opportunity Zone team members: ThompsonHine.com/Services/Qualified-Opportunity-Zones.

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