Tax Alert

Akin Gump
STRAUSS HAUER & FELD LLP

Latest Opportunity Zone Rules Clarify Issues Related to Fund Structuring, Qualifying Businesses and Business Property

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Key Points

- The latest set of proposed opportunity zone (OZ) regulations (the “2019 proposed regulations”) provide much-needed flexibility with regard to qualified opportunity funds (“OZ Funds”) and expand the types of businesses and property that will enable taxpayers to secure OZ tax benefits.
- The 2019 proposed regulations may make it possible to set up a master fund that will aggregate interests, rather than set up a separate fund for each investment, although OZ Fund interests issued in exchange for services, such as carried interest, will not be treated as qualifying investments.
- While the new rules facilitate debt-financed distributions that will not threaten an investor’s OZ tax benefits, some limitations on debt-financed distributions are imposed.
- The income and asset tests that qualified opportunity zone businesses (“OZ Businesses”) must satisfy have been relaxed to enable a broader range of businesses to qualify for OZ investment.
- Real estate located in an OZ can be leased to an OZ Business (even if the OZ Business is a related party) and constitute a “good asset” with no substantial improvement requirement.
- The working capital safe harbor was expanded to benefit OZ Businesses with operating business expenditures, such as salaries, as opposed to just businesses that acquire, construct or rehabilitate tangible property.

While the OZ regime found in Internal Revenue Code Sections 1400Z-1 and 1400Z-2 was signed into law in December 2017, it left gaping holes to be fleshed out in regulations. Many investors and fund managers have been sitting on the sidelines waiting for fundamental questions to be answered in published guidance.

The first set of proposed regulations (REG-115420-18, referred to herein as the “2018 proposed regulations”), issued October 19, 2018, were covered by us in a prior alert. The second set of proposed regulations (REG-120186-18, referred to herein as the

Contact Information

If you have any questions concerning this alert, please contact:

Patrick B. Fenn
Partner
pfenn@akingump.com
New York
+1 212.872.1040

Stuart E. Leblang
Partner
sleblang@akingump.com
New York
+1 212.872.1017

Ron G. Nardini
Partner
rgnardini@akingump.com
New York
+1 212.872.1079

Joshua R. Williams
Partner
jrwilliams@akingump.com
New York
+1 212.872.8014

Lewis J. Kweit
Partner
lkweit@akingump.com
New York
+1 212.872.1041

Olivier De Moor
Partner
odemoor@akingump.com
New York
+1 212.872.1032

"2019 proposed regulations"), issued April 17, 2019, provide additional clarity on a number of important issues, including the following:

OZ Fund Structuring

Acquisition of OZ Fund Interests. Previously, it was only clear that an OZ Fund interest that threw off the sought-after tax benefits could be acquired via a contribution of cash to an OZ Fund. Now, the 2019 proposed regulations also allow an investor to acquire OZ Fund interests for a (noncash) property contribution and by secondary purchase from other persons (e.g., an intermediary or an early-stage, seed or bridge-capital investor). For OZ Fund interests acquired by cash contribution or secondary cash purchase, the 2019 proposed regulations naturally treat the amount of such cash as the amount of the investor's OZ Fund investment.

For OZ Fund interests acquired by property contribution, the investment amount will depend on whether the interests were acquired in a taxable or non-taxable manner. For interests acquired in a taxable manner, the investment amount is the fair market value of such property (and any gain arising from such a taxable transaction is not eligible for deferral under the OZ regime). For interests acquired in a nonrecognition transaction, the investment amount is the lesser of the adjusted basis of the property contributed or fair market value of the OZ Fund interest received (which often will equal the adjusted basis or fair market value of the property given up in the nonrecognition exchange). If the fair market value exceeds the investor's adjusted basis, such excess is a separate investment in the OZ Fund that is not eligible for the OZ tax benefits (i.e., a mixed-funds investment).

Potential Master-Feeder Structures for OZ Funds. The 2018 proposed regulations provided that the gain deferral and/or reduction would be allowed only if the amount of such gains is invested directly in OZ Funds and any gain exclusion would be allowed only by way of a sale of OZ Fund interests. As a result, OZ Fund structures favored a single OZ Fund per investment with shareholders agreeing to allow the manager to have power of attorney to sell the OZ Fund interests on the investors' behalf upon an exit. The 2019 proposed regulations provided much-needed expansion of these rules. This may allow OZ Funds to be formed in more traditional private equity structures, although the rules may still be very restrictive and unnatural to fund managers.

- **Master Funds**
  - The 2019 proposed regulations may facilitate the creation of a single master OZ Fund without the need to create a separate OZ Fund for each investment. Specifically, the 2019 proposed regulations expand the exemption for gain on the sale of interests in an OZ Fund by providing for a new election to allow such exemption to apply to capital gains generated by the OZ Fund on a sale of its own assets. It is effected by way of an exclusion from gross income of the investor's allocable share of the capital gain from the sale.

    Accordingly, the 2019 proposed regulations now allow fund managers to form one aggregating vehicle as the OZ Fund to make different OZ qualifying investments without the need to form a separate fund for each investment. It also would allow the fund manager to control dispositions without the need for investor cooperation on the sale.

Alexander Specht
Partner
aspecht@akingump.com
New York
+212.872.7490

Susan H. Lent
Partner
slent@akingump.com
Washington, D.C.
+1 202.887.4558

John J. Marciano III
Partner
jmarciano@akingump.com
Washington, D.C.
+1 202.887.4450

Geoffrey K. Verhoff
Senior Advisor
gverhoff@akingump.com
Washington, D.C.
+1 202.416.5012

Amy S. Elliott
Senior Practice Attorney
aelliott@akingump.com
Washington, D.C.
+1 202.887.4039

Tuvia Tendler
Associate
ttendler@akingump.com
New York
+212.872.7419

However, as currently drafted, such exemption does not extend to (i) gains from the sale of bad assets (even though the sale of the OZ Fund interest would have covered both good and bad assets, such as intangibles not used in a trade or business or tangible property purchased from a related party) and (ii) gains treated as ordinary income (even though the sale of the OZ Fund interest would have covered such items, such as depreciation recapture or gain from the sale of inventory and other hot assets). In other words, depending on the nature of the investments, a sale of the OZ Fund interests may still be more beneficial than a sale of assets at the OZ Fund level itself.

The 2019 proposed regulations allow the contribution of an OZ Fund interest to an intermediary partnership (even if such partnership is not an OZ Fund itself). Accordingly, after several investments are made through separate OZ Funds, the partners in each OZ Fund can contribute their investments to a new master fund (provided the underlying OZ Funds remain partnerships). That master fund can aggregate investments in various OZ Funds without forfeiting the OZ tax benefits and without being subject to the limitations described above. This structure can allow the sponsor to affect sales of OZ Fund interests at the level of a master fund, providing the investors with the same tax consequences as if they sold the underlying OZ Fund interests themselves. The ability to effect partnership mergers of intermediary partnerships that hold OZ Fund interests may also allow fund managers some fund structuring flexibility.

- **Feeder Funds**
  - The rule described above may also facilitate the creation of feeder funds. Specifically, once an investment in an OZ Fund is made, the partners may contribute their OZ Fund interests to a feeder fund (to the extent treated as a partnership for tax purposes) and continue their entitlements to the OZ tax benefits.

Fund-Level Debt

- **Debt-Financed Distributions**
  - The 2019 proposed regulations clarify that distributions by an OZ Fund not in excess of the investor's tax basis would not trigger the recognition of deferred gain, even if funded from debt taken on by the OZ Fund.

    However, the 2019 proposed regulations turn off OZ tax benefits for OZ Fund investments that are deemed financed by certain debt-financed distributions in cases where the property contributed could be treated as property sold in a disguised sale transaction assuming any cash contributed was property and the partner's share of the partnership's liabilities was zero. Under the relevant disguised sale principles, a distribution within two years is presumed to be a disguised sale. This rule may limit the ability of an OZ Fund to make debt-financed distributions within two years of a contribution.

- **10-Year Exclusion**
  - The 2019 proposed regulations clarify that reductions in the fair market value of an OZ Fund interest attributable to debt do not reduce the amount of excluded gain following the required 10-year holding period, notwithstanding that such exclusion is granted by a step-up of basis to fair market value.

Carried Interest

An OZ Fund interest issued for services (e.g., profits or carried interest) is not eligible for the tax benefits of the OZ regime under the 2019 proposed regulations. Where the same person both receives a carried interest from an OZ Fund and makes an investment in such OZ Fund, the proposed regulations provide that the benefits of the OZ regime are limited only to amounts allocable to the actual investment in the OZ Fund and not on amounts allocable to the carried interest (i.e., a mixed-funds investment).

In addition, the 2019 proposed regulations treat returns as allocable to the nonqualifying carried interest based on the highest residual profits interest percentage, apparently without regard to any investor hurdle or tiered waterfall that often cause carried interest partners to receive less than the highest possible carried interest percentage, and only returns in excess of such highest carried interest percentage are deemed allocable to the carried interest partner's qualifying investment. This allocation rule erodes the OZ regime benefits for carried interest partners' qualifying investments.

To avoid this unfavorable allocation rule, a carry partner may want to consider routing OZ Fund carried interest indirectly through another partnership in which the carry partner will hold an interest (as opposed to carried interest going straight from the OZ Fund to the carry partner that also is making an eligible investment).

OZ Businesses

Income Situs Test

The 2018 proposed regulations require at least 50 percent of the total gross income of an OZ Business to be derived from the active conduct of a trade or business **within** an OZ. The 2019 proposed regulations provide much-needed clarification on this test.

- **Trade or Business**

  The 2019 proposed regulations define a trade or business as a trade or business within the meaning of section 162 (where there is a large body of case law and administrative guidance interpreting the meaning of a trade or business for that purpose). The 2019 proposed regulations also clarify that owning and operating (including leasing) real property is treated as the active conduct of a trade or business, although merely entering into triple-net leases does not qualify.

- **Within a Zone**

  The 2019 proposed regulations provide much-needed clarification of the situs requirement by establishing three safe harbors that are divorced from the business's customer location. Under the first safe harbor, an OZ Business would satisfy this test if at least 50 percent of the time spent by its employees and independent contractors is spent within the OZ. Under the second safe harbor, an OZ Business would satisfy this test if at least 50 percent of the compensation paid by the business is paid to employees and independent contractors that are located within the OZ (so having one highly paid executive located in the OZ can offset having a number of lower-paid employees outside of the OZ).

  Under the third safe harbor, an OZ Business would satisfy the income situs test if the tangible property located in the OZ and the management or operational functions performed in the OZ are each necessary for the generation of at least 50 percent of the gross income of the business. If none of the safe harbors is applicable, the regulations provide for a facts and circumstances test.

Asset Situs Test

The 2018 proposed regulations require that an OZ Business must ensure that for at least 70 percent of its owned or leased tangible property, **substantially all** of the use of such property is in an OZ during **substantially all** of the OZ Business's holding period for such property. These last two "substantially all" thresholds were undefined in the 2018 proposed regulations. The 2019 proposed regulations provide that "substantially all" means 90 percent in the context of the portion of the OZ Business's holding period during which the property must qualify and it means 70 percent in the context of the portion of time that the property must be used in the OZ.

OZ Business Property ("good assets")

Original Use

The 2018 proposed regulations provide that a good asset (other than stock or partnership interests in an OZ Business) is tangible property owned or leased that is either new (original use) or substantially improved. The 2019 proposed regulations provide additional clarification regarding this requirement.

- **First Placed in Service**

  The 2019 proposed regulations provide that the original use of tangible property (other than land) starts on the date such property is first placed into service (by any person) in the OZ for purposes of depreciation or amortization. This allows more OZ investments to qualify. For example, the purchase of a (near) completed renewable project that has not yet been placed in service can now qualify.

- **Vacant Property**

  The 2019 proposed regulations provide that for tangible property (other than land) that has been previously placed in service within the OZ, but was unused, vacant, abandoned or dilapidated for an uninterrupted period of at least 5 years, the original use of such property starts on the date after that period when such property is again placed into service (by any person) in the OZ for purposes of depreciation or amortization.

- **Unimproved Land**

  In general, the proposed regulations clarify that unimproved land satisfies the original use test as long as it is used in a trade or business of the OZ Fund (or OZ Business). Because the holding of land for investment does not give rise to a trade or business, such land could not be qualified OZ Business Property. Additionally, although unimproved land does not need to be substantially improved under the normal substantial improvement test, the 2019 proposed regulations exclude unimproved land from being a good asset if the land was purchased with an expectation, an intention or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase.

- **Buildings and Improved Land**

  Consistent with the 2018 proposed regulations, a building must be substantially improved by doubling its basis (excluding the value of the land underneath it) within

30 months. Land underneath a building qualifies as a good asset if the building above is substantially improved. The proposed regulations are not entirely clear regarding the treatment of land underneath a building as a good asset if the building above is not substantially improved. Nonetheless, the better view is that land underneath a building is a bad asset if the building above is not substantially improved.

Use of Intangibles

The 2018 proposed regulations provide that an OZ Business must use a substantial portion of its intangible property in the active conduct of its business in the OZ. The 2019 proposed regulations define a substantial portion as at least 40 percent for this purpose. This relatively low threshold should facilitate the formation of OZ businesses engaged in science, technology, engineering and math (STEM) fields, as they will presumably have the flexibility to use a larger portion of their intangibles outside of the OZ.

Leases of Tangible Property (including Leases of Real Property)

The 2019 proposed regulations provide much-needed clarification to the requirements applicable to leased tangible property, including real property, to qualify as an OZ Business Property. In particular, leased property is treated as a good asset even if it is leased from a related party and even if it is not substantially improved or originally used by the OZ Fund (or OZ Business). However, such a lease must be entered into after December 31, 2017, and the terms of the lease must be market-based.

Additional requirements exist for certain leases. For leased real property, there may not be a plan to purchase the real property in the future at what would be a discount to fair market value (with fair market value determined without regard to prior lease payments). For related-party leases, the lease cannot provide for a prepayment for a lease period that exceeds 12 months. For tangible personal property previously used in an OZ to qualify by related-party lease, the OZ Fund or OZ Business must also acquire tangible personal property by purchase, and such purchased tangible personal property must be as valuable as such leased tangible personal property.

The 2019 proposed regulations also provide a valuation method for leased property and clarify that such value should be included in both the numerator and denominator of both the 90-percent asset test for the OZ Fund and 70-percent “substantially all” tangible property test for the lower-tier OZ Business. These rules open the door for property owners, including municipalities, to retain control of the land or even of certain public infrastructure (such as a transit hub) while being able to lease development rights to OZ Businesses (e.g., ground leases, air right leases or condominium structuring of vertical ownership).

Cash Reserves

To satisfy the OZ regime, an OZ Fund and an OZ Business is limited in the amount of bad assets it can hold (10 percent at the level of an OZ Fund and 30 percent at the level of an OZ Business). Cash assets are generally treated as bad assets at the level of an OZ Fund and are even further limited at the level of an OZ Business as they cannot exceed 5 percent. Both the 2018 and 2019 proposed regulations provide much-needed flexibility at different levels of the structure.

- **Working Capital Safe Harbor**

  The 2018 proposed regulations provided a safe harbor applicable to OZ Businesses (but not OZ Funds) for reasonable amounts of working capital for the acquisition, construction and/or substantial improvement of tangible property held as cash, cash equivalents or debt instruments with a term of 18 months or less as long as such amounts were expended within 31 months. Under this safe harbor, such cash assets are treated as good assets.

  The 2019 proposed regulations clarify that a single OZ Business can utilize multiple overlapping 31-month working capital periods. The 2019 proposed regulations also expand the safe harbor to allow working capital to be used for the development of a new trade or business in an OZ. Lastly, the 2019 proposed regulations extend the 31-month safe harbor period if the taxpayer has completed an application for government action and the delay is attributable to waiting for such government action.

- **Six-Month Exclusion**

  The 2019 proposed regulations allow an OZ Fund (but not an OZ Business) to exclude from the 90 percent test for six months any capital contributions held as cash, cash equivalents or debt instruments with a term of 18 months or less.

- **Reinvestment Proceeds**

  The 2019 proposed regulations allow the proceeds from a sale or disposition of good assets to be treated as a good asset if the OZ Fund reinvests the proceeds in good assets within the 12-month period following such sale or disposition and the proceeds are held in cash, cash equivalents or debt instruments with a term of 18 months or less. A delay in the reinvestment of such proceeds due to waiting for governmental action will not cause a failure of the 12-month requirement. Reinvestment within such period does not alleviate the OZ Fund investor of the general income tax consequences from gain associated with such dispositions during the 10-year hold period.

Anti-Abuse Provisions

Recognizing that the proposed regulations include many taxpayer favorable rules, the 2019 proposed regulations include anti-abuse provisions to ensure that taxpayers do not take advantage of these rules to achieve abusive results. This is primarily accomplished via the general anti-abuse rule. The general anti-abuse rule allows the Internal Revenue Service to recast transactions that have a significant purpose of achieving a tax result that is inconsistent (based on all the facts and circumstances) with the purposes of the OZ regime.

Additionally, there are several targeted anti-abuse rules aimed at preventing specific abuses such as (i) generating OZ tax benefits from land banking; (ii) avoiding the substantial improvement requirement via a lease with a plan for a later below-market sale and (iii) creating artificial eligible gain via straddles and offsetting position transactions.

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