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## **INSIGHT: Latest Round of Opportunity Zone Regulations Clarify Some Issues, Leave Others Murky**



BY FORREST MILDER

The IRS and Treasury released another round of eagerly awaited proposed opportunity zone regulations on April 17. The regulations answer some but not all questions asked by attorneys and potential investors.

### **Broad Statements—Subsequently Qualified**

It's obvious that a great deal of work has gone into this, and the number of fact patterns addressed, and the favorable basic rules are most impressive. Still, the Internal Revenue Service has a way of writing broad favorable statements and then taking some of it back if you keep reading. For example, the regulations tell us that real estate leasing is an active trade or business, and okay, and then later on telling us that a mere triple-net lease does not qualify. This IRS technique (of asserting a blanket rule and then contradicting it a few pages later) appears several times in this round of the regulations, and makes me wary of offering blanket statements about what the rules do and don't provide.

### **Basis Step-Up**

The ability to step up the basis in assets inside an opportunity fund (O-Fund) once the interest has been held for 10 years is a huge change. If the basis step-up happens inside, then you needn't form multiple O-Funds in order to facilitate later sales. Once the 10-year hold has elapsed, a single fund can just sell individual assets as buyers appear, and avoid the post-10 year tax.

However, consistent with my first observation, I still want to read the regulations again to verify that the IRS hasn't eliminated some problems but left behind others.

My concern is whether the step-up also applies to assets held within a "subsidiary entity" one step down from the O-Fund. Yes, I know that the answer should be the same, but I still want to be sure.

And, of course, the new rule does not apply to sales if the interest has been held for less than 10 years. Sales within the 10-year period (a) will be taxable and, (b) must be reinvested within 12 months to not impair the O-Fund's status.

### **Section 1231 Gains**

A new rule provides that tax code [Section 1231](#) gains don't have to be invested until 180 days after the end of the year. Section 1231 gains are the ones derived from the sale of property used in a trade or business. In particular, this refers to other real estate a taxpayer may own, which it now sells and uses the resulting gain to invest in an O-Fund. This is a much more beneficial rule than the one that applies to sales of investments (e.g., stock) where the 180 days is measured from the date of sale.

### **Ninety Percent Deadline**

I had written to the IRS (and no doubt others had too) that the rule which required a fund to pass the 90 percent test by the earlier of six months, or the end of the year, would highly discourage second-half-of-the-year investing. Essentially, under the old rules, a fund that was formed on July 1 had till December 31, i.e., six months, to pass the test, while a fund formed on November 30, also had till December 31, i.e., just one month.

Accordingly, I thought that there would be material drop-off in investing as the year wore on. I was pleased to see that the IRS took the issue to heart! Interestingly, they provided a more favorable solution than I had expected.

The new rule provides that investments into the O-Fund within the past six months simply don't count. This can buy an investor as much as nearly a year to make investments. For example, an investment made on August 1 will be ignored on December 31 in computing the 6-month test. It won't be considered until the following June 30 for a calendar year fund.

## Depreciation Recapture

The IRS didn't specifically mention "depreciation recapture" in the new regulations or the discussion that accompanies them. However, as I noted above, the regulations do provide for a basis step-up to fair market value for assets held inside the fund, once the investor holds its interest for at least 10 years.

This should mean that depreciation recapture is no longer a problem. I say "should" because I must observe that the IRS's "notes" that accompany the regulations specifically refer to receivables and inventory as not resulting in ordinary income, without mentioning depreciation recapture. Receivables and inventory are typically mentioned along with depreciation recapture as the three "hot assets" associated with partnership sales, so if the step-up works for the one, it should work for all three.

This should be significant where personal property is involved. For example, if a renewables facility is acquired for \$10 million, depreciated to zero, and then sold after 10 years for \$3 million, this \$3 million gain should be tax free, and not subject to ordinary income treatment as depreciation recapture.

I will certainly try to find out why the IRS didn't include depreciation recapture in their notes. Truth is, it shouldn't matter, since the basis step-up called for in the regulations should assure that result anyway.

## 'Mere' Triple-Net Leasing

As I noted above, the IRS, in a somewhat convoluted fashion, said that real estate leasing is an active trade or business, and then a few pages later, said that "mere" triple-net leasing is not. Of course, this means that we are now left to interpret the word "mere." I'd say that having some ongoing management function is probably sufficient.

## Used Property

Used property, requiring the O-Fund to undertake a rehabilitation, does not include:

- (1) property not yet depreciated by anyone (e.g., an about to be finished building that the O-Fund buys from someone else before it is placed in service),
- (2) property not yet placed in service in the zone (e.g., computer equipment moved from elsewhere), and
- (3) real estate that is previously used, but has been vacant for at least five years.

These are all worthy objectives.

On the other hand, the IRS still hasn't decided whether the requirements of expenditures "with re-

spect to" used property can include an adjacent building, or buying new property to be used with the old. For example, this might include construction of a new shopping area along side a used residential building. The IRS specifically ask for comments on whether an "aggregate approach" makes sense. I suggested interpreting "with respect to" in this way in a letter back in July, even before the first regulations were published; I plan to make the suggestion again.

## Related Party Leases

The proposed regulations provide significant latitude in leasing activities that require discussion beyond the scope of this article. Still, the most obvious new feature is that an O-Fund can lease property from a related party, a big benefit for assets owned prior to 2018, provided the lease doesn't have prepayments that apply to more than a 12-month period. Note, that all leases (even with third parties) must be at market rate.

## Active Trade or Business

The "active trade or business in the zone" test now calls for one of three tests to be passed. The first two are a 50 percent computation related to providing services, based on hours billed or compensation.

However, these new rules don't just apply to employees. The test also includes independent contractors, which complicates matters, in my judgment. If a software company has ten software engineers in the zone who make \$360,000, and five sales people making \$200,000 outside the zone, it seems to pass. But suppose they also hire an independent sales force, and pay them \$200,000? What record-keeping is called for here? Don't we need to know where the independent team works, how much the people are actually paid, etc.? And, aren't they "independent," so that they are unlikely to share their records with us?

This may be overcome by the third test, which considers tangible property and significant management function in the zone. Finally, when all else fails, the business can apply a "facts and circumstances" test. All things considered, I think that these solutions to the active trade or business in the zone test may still need some work.

## 'Inclusion Event'

The term "inclusion event" is new to these regulations, and it may create "traps for the unwary." Plainly, the IRS doesn't want taxpayers coming up with ways to dispose of their investment in an O-Fund without paying the deferred tax, but the rules are complex and not entirely consistent.

If anything in the new rules creates a "lawyer's relief act," this is it. Almost any time someone contemplates a reorganization or a distribution, analysis will be necessary. However, the simple distribution of cash that doesn't exceed basis is okay, and the regulations do have an illustration where the distribution is financed by an entity-level borrowing.

But note that the debt almost certainly has to be allocated to the investor receiving the distribution in order for it to have the required basis. For example, a borrowing guaranteed by the managing member and a subse-

quent distribution to the investor member will likely be taxable, while a loan that is nonrecourse, and allocated among the investors in accordance with the tax rules should give each member basis, and therefore yield the expected no tax result.

## Service Provider Interests

The IRS has provided a rule for O-Fund interests received by service providers: the portion received for services doesn't qualify for favorable treatment, which may necessitate appraisals. Still, with proper structuring, I can make good arguments for not needing a valuation, based on long-standing precedents.

## Property Contributions

The IRS has provided a somewhat complex set of rules that apply when property (as opposed to cash) is contributed to an O-Fund. Valuations and basis computations are called for, and the investor can wind up with a part qualified/part unqualified capital contribution. Remember that an investment in a subsidiary entity still must be cash, as required by the tax code provision.

## Conclusion

It should be noted that the IRS has also identified many spots in which it is seeking suggestions on how to address some pretty broad fact patterns. I highlighted a

few above, but there are several others. So, we still have plenty of loose ends. And, I have barely scraped the surface of all the rules included for corporate transactions. There are large sets of rules for S corporations and consolidated groups, for example.

Finally, there are new concepts that call for further thought. For example, there's a provision permitting one investor to sell its interest to another investor, with the latter qualifying for favorable O-Fund treatment, based on the amount paid to the first investor, something which isn't obvious from the Code provision.

Still, one has to applaud the extraordinary government effort that is apparent here. The depth of the rules and the anticipation of potential problems and opportunity for abuse is exceptional. And this should do the trick of getting a lot more investors into the marketplace. There's plenty enough guidance to satisfy even those who tend to over-worry their tax analysis.

*This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.*

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