A Deeper Dive into the Second Tranche of Opportunity Zones Regulations: Benefits and Pitfalls (Part II)

Published by Michael Novogradac on Friday, April 26, 2019 - 12:00am

As investors, business owners and fund managers, and their tax advisors, continue to review the recently released proposed opportunity zones (OZ) regulations, a number of issues and likely effects have been identified, and many continue to be discussed and evaluated. Additional guidance and clarification will be needed from Treasury and the Internal Revenue Service on many of these issues and possible effects.

That said, the second tranche of regulations provided more guidance in a broader range of areas than many expected, which has led Treasury to mention that a third tranche of regulations may, emphasis on may, not be needed. That prospect is considered in more detail below.

In addition to those issues discussed in Part I of this discussion, some of the issues getting the most attention include:

- the greater predictability of the tax treatment of distributions of refinance proceeds by qualified opportunity fund (QOF) partnerships;
- the ability to exclude gain from certain QOF partnership asset sales;
- clarifications regarding valuing a QOF Interest in 2026 as well as for QOF investments held for 10 years;
- the potential for the creation of a secondary market for interests in QOF investments; and
- the possible use of feeder partnerships.

### Distributions of Refinance Proceeds

The proposed regulations generally provide that a distribution of cash to a QOF partnership investor is only taxable to the extent the distribution of cash exceeds the partner’s basis in their interest, including allocable debt. This provision, on its surface, confirms the ability of a QOF partnership to make nontaxable distributions of refinance proceeds. However, a key exception provides that the distribution of proceeds within 90 days of borrowing will accelerate investor deferred gain to the extent the cash exceeds the partner’s basis in their partnership interest, excluding allocable debt. This rule, in isolation, would severely limit the ability of a partnership to timely distribute refinance proceeds to its investors.

However, it appears that this 90-day limitation generally applies only during the first two years of a partner’s investment in a QOF. An example in the proposed regulations suggests outside the two-year window, the 90-day rule doesn’t apply. Further note, however, the distribution of refinance proceeds beyond the two-year window would accelerate deferred gain to the extent, based on a facts and circumstances test, the distribution should be treated as a disguised sale of a partnership interest under IRC Section 707.

**Property Sales – QOF or Qualified OZ Business?**

The proposed regulations allow investors in partnership and S Corporation QOFs, for interests held at least 10 years, to elect exclude gain allocated to them by the QOF from the QOF’s sale of qualified OZ property (allocable direct QOF capital gain). However, the regulations do not clearly extend the gain exclusion election to allocable indirect QOF capital gain. Allocable indirect QOF capital gain is capital gain allocated to the QOF investor by the QOF that is attributable to gain allocated to the QOF by a qualified OZ business upon the sale of assets by the business.

Also, note that if the QOF or qualified OZ business generates ordinary income on the sale of depreciated personal property, such income does not appear to be excludable by the investor. As such, QOFs with significant value associated with direct or indirect interests in depreciated personal property will not benefit from the exclusion election.
for allocable QOF capital gain. As such, a sale of a QOF interest would be the preferred exit strategy in those circumstances.

Gain Recognition in 2026 and after 10 Years

The proposed regulations provide useful clarity to the valuation of QOF partnership interests, both as of Dec. 31, 2026 and upon sale after having held an interest in a QOF for at least 10 years.

On Dec. 31, 2026, investors in partnership QOFs will recognize deferred gain equal to the lesser of: (1) the deferred gain in excess of the 10 percent and 5 percent basis adjustments, as applicable, or the (2) gain that would be recognized on a fully taxable disposition of the interest. For QOF partnerships invested in real estate, the gain recognized would generally equal any losses allocated to the partner plus any non-taxable cash distributions plus the fair market value of the partnership interest, reduced by the 10 percent and 5 percent basis adjustments, as applicable. After holding an interest for 10 years, the basis of the partnership interest is adjusted to an amount equal to the fair market value of the interest, including debt, and immediately prior to the sale or exchange, the basis of the QOF partnership assets are also adjusted.

The net effect of this provision is that to the extent a partner has a negative tax basis capital account, such negative capital account will not generally result in taxable gain to a partner. Some practitioners colloquially refer to this as confirming that depreciation expense is not recaptured.

Secondary Market in Opportunity Funds?

The proposed regulations provide that if a taxpayer acquires a direct investment in a QOF from a direct owner of the QOF, the taxpayer is treated as making an investment in an amount equal to the amount paid for the eligible interest, with the buyer’s holding period in the QOF interest beginning on the date of purchase rather than including the seller’s holding period. This provision may give comfort to many QOF investors that a secondary market may develop for their QOF investments. However, this provision may prove a challenge for fund managers who are seeking to manage their funds in a fashion that will generate the 10-year hold benefit for their investors.

Feeder Partnerships

The proposed regulations generally provide that a contribution by a QOF owner of its direct or indirect partnership interest in a QOF to a partnership is not an inclusion event. The transferee partnership becomes subject to section 1400Z-2 and the regulations thereunder with respect to the eligible gain associated with the contributed qualifying investment. Also, the transferee partnership must allocate and report the gain that is associated with the contributed qualifying investment to the contributing partner to the same extent that the gain would have been allocated and reported to the contributing partner in the absence of the contribution.

Many opportunity fund managers have chosen to form multiple sidecar single-asset QOFs, and achieved diversity by having their investors make separate investment in each fund. The use of an intermediate partnership would allow QOF managers to simplify the management and reporting of these QOF investments for their investors. Furthermore, as lower-tier opportunity fund investments mature, the upper-tier intermediate partnership could sell its lower-tier opportunity fund interests, or make the necessary gain exclusion elections on behalf of its investors.

Intangible Property

The proposed regulations provide that, for purposes of determining whether a substantial portion of intangible property of a qualified opportunity zone is used in the active conduct of a trade or business, the term substantial portion means at least 40 percent. The regulations also provide a working capital example of a business that plans to use cash invested to research and develop a new application of existing software to be marketed to government agencies. This example appears to confirm that developing new technology in an OZ for use by customers outside the OZ will satisfy the requirement that intangible property be used in the active conduct of a trade or business in the qualified OZ. Left unanswered are:

- the meaning of the phrase “used in the active conduct of a trade or business” in other contexts;
- a method for measuring the portion of intangible property used in a business; and
- a method for determining whether a business’s intangible property is used in the OZ.

Applicability Dates

Again, the second tranche of regulations provided more guidance in a broader range of areas than many expected and Treasury has indicated a third tranche of regulations may not be needed. If true, the question becomes will Treasury re-
propose the current two tranches or finalize them? This is a particularly interesting question given the applicability
of the second tranche of regulations.

Specifically, with one notable exception, taxpayers may generally rely on the second tranche of regulations for periods
prior to the finalization if they apply the proposed rules consistently and in their entirety. The one exception is that
Treasury’s allowance of pre-finalization reliance does not apply to the rules regarding the election to adjust the basis of
an interest in a QOF (or certain eligible property held by the QOF) for an investment that is held for at least 10 years
(proposed §1.1400Z2(c)-1), as these rules do not apply until Jan. 1, 2028.

Bottom Line: Regulations Should Accelerate Investment in Distressed Areas

The second tranche of proposed OZ regulations provides guidance in a broad range of areas and will lead to more
investment in OZs, particularly in operating businesses. The clarifications provided for real estate financing and for
unwinding opportunity funds after 10 years should also lead to higher levels of investment in distressed areas.

To continue to process and understand the second tranche of proposed OZ regulations, Novogradac will host a
Novogradac Opportunity Zones Regulations Webinar on May 14 that will look at the points discussed here, and answer
questions posed by attendees.