



Qualified Opportunity Zone Alert

May 2019

Opportunity Zone IRS Guidance: Round Two Outline

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 toward 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 simply a bullet point outline highlighting topics that have been discussed in connection with structuring and implementing 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 (QOF) reporting and revisions to IRS Form 8996 filed with the election of QOF status and annual filings thereafter. A more [detailed explanation of the Round Two Guidance](#) can be accessed on our website.

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.

What's Next?

1. The 2018 proposed regulations will be revised and issued in final form.
2. Comments will be submitted and a hearing held on the Round Two Guidance to be followed by the issuance of such regulations in final form.
3. 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 an OZ business.
4. 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 data, (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.
5. 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 percent exclusion of the deferred gain for 2020 investments in a QOF.
6. Pursuant to a Presidential executive order, a report is to be issued by 13 federal agencies in December 2019 to assist distressed areas, including OZs.

Effective Date of Round Two Guidance—Many parts of Round Two Guidance can be applied and relied on by taxpayers before issued in final form, but only if the taxpayer applies these rules in their entirety and in a consistent manner.

Outline of Round Two Guidance

1. Extension of 180-day period to invest certain capital gains (Section 1231 Gains).
 - a. Determine what is 1231 property.
 - b. Taxpayer Section 1231 Capital Gains versus straight capital gain.
 - i. Net amount limitation.
 - ii. 180-day investment period starts at end of the year.
 - A. Extends 2018 Section 1231 Capital Gains until end of June 2019.
 - B. Provides much more time for 2019 Section 1231 Gains.
 - c. Structuring consideration if plan to invest in QOF early.
 - d. Distinguish 180-day rule applicable to pass-through entity (LLC/partnership/S corp).
2. Time for QOF to meet the 90 percent requirement—revised but limited effect.
 - a. For first contribution to a QOF, skip over first testing date.
 - b. Provides up to six additional months to invest cash amount in second-tier operating entity.
 - c. Preferred approach remains use of second-tier operating entity.
 - d. Longer period to apply the cash when combining lengthier 180-day period to make investment of 1231 property sale proceeds, up to six additional months for QOF to make investment, and application of 31 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 seems less than understood under 2018 proposed regulations.
 - a. Identification of specific building or land to be purchased or leased seems to have been softened.
 - b. Permitted delay based on required governmental action.
4. Use of capital gain dollars toward startup tech companies. Expansion of 31-month safe harbor beyond the acquisition, construction and/or substantial improvement of tangible property to development of a business and other favorable points.
5. Real property straddling the QOZ can be treated as QOZ property for certain purposes.
6. Sale of operating assets and reinvestment of cash proceeds within 12 months does not impact the 90 percent QOF requirement, but triggers gain and needs additional work.
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.
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.
9. Contribution of appreciated property to a QOF in exchange for an interest—can get complicated.
10. Confirmation that tax basis of QOF interest is increased by financing at LLC levels.
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. Works on sale of interest in QOF.

Effect: Continue considering separate fund for each project and have exit through sale of LLC interest, until clarified.
12. Confirmation that at five-year and seven-year holding period when 10 percent and 15 percent 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.
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.

Effect: Individual who 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. Tax basis of assets acquired by the QOF or the second-tier operating entity with invested capital gain proceeds is cost.
- 16. Active conduct of a business—continue to stay away from triple-net-lease.
- 17. “Substantially all” of the use of the qualifying QOZ tangible business property must be in an OZ, which is defined as at least 70 percent of such use. Inventory (including raw materials) in transit to OZ business or from OZ business to customer counted as used in OZ.
- 18. 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.

Examples:

- 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 percent 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 as purchased and qualify as original use.

- 19. 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 percent qualifying tangible property requirement.
- 20. Leased property: special favorable rules added.
- 21. Further structuring consideration needed for building that needs substantial improvements and its owners have eligible capital gain.

FOR MORE INFORMATION

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