



## Client Alert: New Proposed Regulations Provide Additional Clarity for Investments in Qualified Opportunity Funds

The Department of Treasury issued additional Proposed Regulations (the “New Regulations”) on the Qualified Opportunity Zone program (the “QOZ Program”) on April 17, 2019 (available [here](#)). The Department of Treasury previously issued initial Proposed Regulations on October 19, 2018 (the “Initial Regulations”), and we previously circulated a Client Alert (available [here](#)) that provides a brief summary of the QOZ Program and the Initial Regulations.

The New Regulations provide significant guidance in connection with the QOZ Program, including guidance on formation of a Qualified Opportunity Fund (“QOF”), investments in a QOF, and QOF investments in Qualified Opportunity Zone Businesses (“QOZB”). This Client Alert summarizes some, but not all, of this guidance. While there are still a number of questions outstanding, the New Regulations should enable many investors (“QOF Investor”) in a QOF and fund sponsors to move forward with investments in Qualified Opportunity Zones (“QOZ”).

### Investors in Qualified Opportunity Funds

#### Qualifying Investments

The New Regulations permit a QOF Investor to contribute any property (not simply cash) to a QOF in exchange for a qualifying interest in the QOF (the “QOF Interest”). Although this new rule provides additional flexibility, the contribution of property to acquire a QOF Interest is subject to a number of special rules. Also, the contributed property would not constitute good qualified opportunity zone business property (“QOZBP”) – good QOZBP must be acquired by purchase – and would count against the 90% asset test or 70% asset test, as applicable (the “Asset Tests”). The New Regulations also provide that a QOF Interest issued in exchange for services does not qualify for any of the QOZ Program benefits, denying the QOZ Program benefits to promotes and carried interest.

#### Debt Financed Distributions

The New Regulations confirm that general partnership income tax rules regarding allocation of partnership debt apply to a QOF that is a partnership for income tax purposes (“QOF Partnership”). Therefore, a QOF Investor in a QOF Partnership may increase its QOF Interest basis for any QOF Partnership debt allocated to it and potentially take distributions without gain recognition to the extent of such basis. Notably, however, the New Regulations borrow (and expand upon) principles from the disguised sale rules under Section 707 of the Internal Revenue Code of 1986, as amended (the “Code”), and potentially deny QOZ Program benefits for an investment (including cash investments) in a QOF Partnership if there is a related distribution to the QOF Investor (which is presumed if the distribution is made within two years of the QOF Investor receiving its QOF Interest).

#### Transfers of QOF Interest Prior to December 31, 2026

The New Regulations contain a non-exhaustive list of transactions that would cause a QOF Investor’s deferred gain (less the 5-year and 7-year basis step-up, if applicable) to be recognized prior to the December 31, 2026 recognition date, including events that are in the QOF Investor’s control and the QOF’s control. The New Regulations do provide that a transfer of a QOF Interest upon death of a QOF Investor is not such an event requiring the deferred gain to be recognized, but Section 1400Z-2(e)(3) of the Code (which governs the QOZ Program) specifically provides that this deferred gain is income in respect of a decedent for tax purposes (i.e., the QOF Interest does not receive a step-up in basis at the QOF Investor’s death). As a result, while the transfer of a QOF Interest upon death is not an event triggering the recognition of the deferred gain, the estate, beneficiary, or other holder of the QOF Interest would be required to recognize the deferred gain (less the 5-year and 7-year basis step-up, if applicable) on December 31, 2026, unless such deferred gain had already been recognized.

#### Sale of Qualified Opportunity Zone Business Property

The New Regulations provide a QOF Investor in a QOF Partnership (or other QOF that is a pass-through entity for income tax purposes) with an election to exclude capital gain allocated from a QOF's sale of QOZBP, but only if the QOF Investor held its QOF Interest for the requisite 10-year holding period at the time of such sale. Prior to this clarification, a QOF Investor was required to sell its QOF Interest to take advantage of the exclusion of appreciation for QOF Interests held for more than 10 years.

Importantly, however, based on the terms of the New Regulation, this election to exclude gain only applies (i) to capital gains (i.e., the election does not apply to allocations of ordinary income), (ii) the sale of QOZBP (i.e., the election does not apply to the sale of non-QOZBP), and (iii) if the QOF Investor held its QOF Interest for the 10-year holding period. If the QOF sold its QOZBP prior to such 10-year holding period, the New Regulations permit the QOF to reinvest the proceeds from such sale with replacement QOZBP during the following 12-month period to meet the Asset Tests, but the New Regulations confirm that the gain from such sale is allocated to the QOF Investor and the QOF Investor would not be permitted to exclude such gain from its income.

## **Qualified Opportunity Funds**

### Leased Tangible Property

The New Regulations confirm that leased tangible property may qualify as QOZBP, and therefore, count towards both of the Asset Tests. Unlike tangible property purchased by the QOF, however, the QOF may lease tangible property from a related person, subject to certain rules and limitations. This clarification permits parties that currently own real estate in a QOZ that was purchased prior to December 31, 2017 to take advantage of the QOZ Program and its benefits. In addition, this clarification provides much needed guidance to operating businesses looking to participate in the QOZ Program, especially those with significant leased property.

### Active Trade or Business

In order to qualify as a QOF, the QOF must either operate a trade or business directly or own an equity interest in an entity that operates an active trade or business that is a QOZB. The New Regulations provide clarity on these rules, including that the ownership and operation (including leasing) of real property is the active conduct of a trade or business for purposes of the QOZ Program. The New Regulations, however, provide that merely entering into a triple-net-lease is not the active conduct of a trade or business.

### Working Capital Safe Harbor

The New Regulations added two significant revisions to the working capital safe harbor. First, the working capital safe harbor now applies to the use of funds for the development of a trade or business, as opposed to just the acquisition, construction and/or improvement of tangible property that was required under the Initial Regulations. This is a welcome addition for operating businesses desiring to take advantage of the QOZ Program. Second, the New Regulations provide that any delay in the 31-month working capital period that is attributable to waiting for government action (e.g., permits or zoning) would not violate the working capital safe harbor.

### Unimproved Land and Vacant Properties are not Required to be Substantially Improved

The New Regulations provide additional clarity and flexibility for unimproved land and vacant properties. First, the New Regulations confirm that unimproved land does not need to be substantially improved. Second, real property purchased by a QOF that has been vacant for at least five years prior to the QOF's purchase is deemed to satisfy the original use requirement, and therefore, is also not required to be substantially improved. In both cases, however, the New Regulations confirm that the properties must be used in a trade or business, and therefore, simply acquiring unimproved land or vacant properties (i.e., "land banking") will not qualify for the benefits under the QOZ Program.

### Gross Income from QOZBP

The New Regulations provide clarity for a QOF's investment in a QOZB operating business. The Initial Regulations required that a QOZB have at least 50% of its gross income derived from the active conduct of a trade or business within a QOZ ("Gross Income Test"), but did not further define how this Gross Income Test could be satisfied. The New Regulations provide that a QOZB satisfies the Gross Income Test if any one of the following safe-harbors are met: (i) if 50% or more of the services performed for the QOZB, based on hours worked, are performed in the QOZ; (ii) if 50% or more of the services performed for the QOZB, based on amounts paid for the services, are performed in a QOZ, or (iii) if the tangible property and management (or operations) necessary to generate 50% of the QOZB gross income are located within the QOZ. If a QOZB fails to meet one of these three safe-harbors, the QOZB may still satisfy the Gross Income Test by establishing that 50% of its gross income is derived from the active conduct of a trade or business based on a facts and circumstances analysis.

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If you have any questions regarding the contents of this Client Alert or investments in Qualified Opportunity Funds, please contact:



**Justin Wallace**  
[justin.wallace@hwhlaw.com](mailto:justin.wallace@hwhlaw.com)  
813.506.5137



**Prestin Weidner**  
[prestin.weidner@hwhlaw.com](mailto:prestin.weidner@hwhlaw.com)  
813.222.3122



**Katie Cole**  
[katie.cole@hwhlaw.com](mailto:katie.cole@hwhlaw.com)  
727.259.6791



**Ben Dachepalli**  
[ben.dachepalli@hwhlaw.com](mailto:ben.dachepalli@hwhlaw.com)  
813.227.8439



**Katherine Frazier**  
[katherine.frazier@hwhlaw.com](mailto:katherine.frazier@hwhlaw.com)  
813.227.8480



**Jerilyn Reed**  
[jerilyn.reed@hwhlaw.com](mailto:jerilyn.reed@hwhlaw.com)  
813.222.3119

