How the Latest IRS Opportunity Zone Regulations Help Real Estate Developers Qualify for Opportunity Zone Tax Benefits

By Catherine Holmes, Brad Cohen and Jamie Ogden

The latest IRS Proposed Regulations Released April 17, 2019 provide greater flexibility to real estate developers seeking capital from investors for Opportunity Zone projects.

Some of the problems posed for real estate developers and others under the new Opportunity Zone ("OZ") tax incentive program, codified as Sections 1400Z-1, and 1400Z-2 of the Internal Revenue Code, have been potentially solved by the latest round of IRS proposed regulations. In particular, the proposed regulations now provide helpful guidance and assurance regarding:

- development of property that was acquired by a developer prior to December 31, 2017;
- clarification regarding when real property will be considered to meet the "original use" requirement;
- capital contributions received from new investors in a "qualified opportunity fund" (or "QOF") with multiple closings;
- distributions of debt financed proceeds by a QOF to investors during the 10 year required holding period;
- greater flexibility to deal with "real world" problems (such as delays in governmental permitting);
- sales of assets by QOFs before the 10-year holding period for investors and reinvestment of proceeds of sale;
- sales of assets by QOFs organized as limited liability companies or limited partnerships after the 10 year holding period for investors;
- clarification that a property rental business is considered an active trade or business (other than a triple net lease);
- and
- clarification that depreciation recapture should not be taxable upon a sale of property by a QOF.

This article explains how these new proposed regulations help real estate developers and their eligible investors qualify for the tax benefits under the OZ program. For information regarding the potential benefits to investors in a QOF and the basic requirements necessary to qualify as a QOF, see our prior article “How Real Estate Developers Can Use Opportunity Zone Funds to Finance New Real Estate Projects.”

Real property acquired before December 31, 2017 can now qualify for development by a QOF through a ground lease arrangement between a real property lessor and an affiliated real property lessee.

One of the requirements for a real estate development to achieve the status of "qualified opportunity zone business property" ("QOZBP") under Section 1400Z-2 is that the property being developed must have been purchased after December 31, 2017. Developers who acquired their properties before that date were prevented from qualifying for the OZ tax incentives unless they sold at least 80% of the property to an unaffiliated purchaser, and retained no more than a 20% capital and profits interest. However, the latest proposed regulations offer another option to a developer in this situation – it can form an affiliated QOF, enter into a ground lease with the QOF as lessee, and have the QOF finance the development of the property. The requirements for ground leases between affiliates under the latest OZ regulations are that:
the lease is entered into after 2017;
the lease is on market rate terms when it is entered into;
the lease does not contain a prepayment of more than 12 months;
there is not a plan, intent or expectation that the QOF would purchase the property for other than fair market value to be determined at the time of purchase.

Real property will meet the “original use” requirements if it has been vacant for at least 5 years or has never been placed into service.

The second set of proposed OZ regulations state that property that has been unused or vacant for an uninterrupted period of at least five years before it is acquired or put in service by the QOF will be considered “original use.” In addition, if a real property has completed development, but has not yet been placed into service when it is acquired by the QOF, it may meet the “original use” requirement. This means that the QOF will not have to meet the “substantial improvement” test with respect to such property, meaning that the QOF will not have to make improvements to the property that are at least equal to 100% of the value of the property when it is acquired by the QOF.

Capital contributions acquired in multiple closings over time will not count towards the 90% asset test required for qualification as a QOF for a period of six months after each contribution.

One of the requirements for qualification as a QOF is that at least 90% of its assets are “qualified opportunity zone property”, which may include stock of a qualified corporation, partnership interests of a qualified partnership or “qualified opportunity zone business property” (“QOZBP”). A QOF that receives capital contributions in multiple closings over a period of time, which is common in real estate development partnerships, could have difficulty qualifying the proceeds of the capital contributions for a period of time while the QOF determines how those proceeds will be used. The latest OZ regulations solve this potential problem by providing that a QOF may exclude any cash or property contributed to the QOF in exchange for stock or partnership interests for a period of up to six months. Any cash contributions are required to be held in cash, cash equivalents or debt instruments with a terms of 18 months or less in order to qualify for this six month exclusion.

Distributions of proceeds from a qualified mortgage financing by a QOF to its investors would not be taxable, and could provide cash for payments of tax liabilities incurred prior to the end of the 10 year holding period.

One of the difficult issues presented under the original OZ program is that investors in a QOF are required to pay the tax on the lesser of their original deferred capital gain used to make their investment in the QOF or the fair market value of the investment in the QOF by no later than December 31, 2026, which is before the end of their 10 year holding period for non-recognition of capital gains tax on the QOF investment. Where would the investors obtain the cash to pay the tax due at the end of 2026?

The latest proposed regulations provide a potential solution for that issue by allowing a distribution of financing proceeds from a QOF partnership to investors in an amount that does not exceed each investor’s tax basis in its QOF interest. This provision is particularly important for QOFs invested in real estate, because non-recourse debt financing secured by real property owned by a QOF is allocated to the basis of each investor in the QOF. This means that the QOF can make
distributions of cash to each investor in the QOF up to the amount of basis allocated to that investor from the non-recourse debt financing.

However, the proposed regulations provide that the disguised sale provisions apply to cash contributions to a QOF during the first two years after the cash contributions are made to a QOF, and that there is no increase in basis to investors in a QOF for non-recourse debt financing during that two year time period. Therefore, a QOF needs to carefully analyze distributions of debt-financing proceeds during the first two years following investment by qualified investors in the QOF.

**Delays in deployment of investor funds by a QOF caused by delays in government permitting will not cause a QOF to lose its working capital safe harbor.**

The first set of proposed OZ regulations issued in October 2018 allowed QOFs a period of up to 31 months to deploy the cash capital contributions received from investors into QOZP. The problem this presents for real estate development projects by a QOF is that the governmental entitlement and permitting process can often take years to complete, and construction cannot commence until those permits are in place. Delays in the permitting process could cause a QOF to exceed the 31 month period before investor capital is used for construction. This problem has been addressed by the second set of proposed OZ regulations, which now provide that delays caused by governmental permitting will not cause a QOF to lose the safe harbor, so long as the required permits were applied for prior to the end of the 31 month period.

**The proposed regulations clarify that a QOF may engage in a property rental business (other than a triple net lease).**

Before the second set of proposed regulations were issued, there was some concern expressed by commentators that it was not clear whether a QOF operating a property rental business, such as multifamily rental apartments, was engaged in an "active trade or business" as required by the OZ program. The proposed regulations state expressly that real estate leasing meets the business requirement, which should provide comfort to real estate developers of rental housing projects. However, the regulations also confirm that **mere triple net leasing** is not an active trade or business. This is generally considered to mean that the QOF must have some active role in management of the property, which is not typically present in a triple net lease arrangement.

**QOFs may sell property before the end of the 10-year holding period required for investors to realize tax free capital gains, provided the proceeds are reinvested within 12 months in new QOZP – although investors will be subject to tax on their allocated share of any capital gain realized by the QOF as a result of the sale.**

Developers of real property may determine that changes in economic, geographic or other factors require that a property be sold before the end of the 10 year holding period required for investors in a QOF to receive the tax benefit of tax-free capital gains on their investment in the QOF. The second set of proposed OZ regulations now provides that if the QOF does sell a QOZP before the end of the 10 year holding period, the QOF will retain its qualification as a QOF, and the investors in the QOF will retain their original 10 year holding period, so long as the QOF reinvests the proceeds of the sale of the QOZP within 12 months into new QOZP. This provides some needed flexibility to QOFs to meet changes in circumstances that require sales of QOZP.

However, the Treasury Department stated that it did not believe it had authority to defer the tax payable by investors in the
QOF on their allocated share of any capital gains from the sale of the QOZP by the QOF. This means that investors in the QOF will not receive the benefit of tax deferral of any sales of QOZP before the 10 year holding period, but could at least receive the benefit of tax free capital gains from the sale of the QOZP purchased with the reinvestment of the proceeds of the initial sale of QOZP by the QOF. In addition, it is possible that the investors who realize capital gains from the sale of the QOZP before the end of the 10 year holding period could reinvest those proceeds into another QOF investment, and thereby defer the recognition of gain caused by the sale of QOZP by the QOF.

Investors in QOFs organized as limited liability companies or limited partnerships may receive the benefit of tax free capital gains for inside sales of assets by the QOFs after the investors’ 10 year holding period.

The initial OZ proposed regulations required investors to sell their outside interests in the QOF in order to realize the benefit of tax free capital gains on the sale of their investment. The second set of proposed regulations now allows the investors in the QOF to retain their investment in the QOF and make an election to exclude from gross income some or all of the capital gain allocated to the investors by the QOF attributable to the sale of the QOZP inside the QOF after the investors’ 10 year holding period is completed.

The proposed regulations clarify that depreciation recapture should not be taxable upon sale of an investor’s interest in a QOF.

One of the most frequently asked questions by real estate investors regarding the tax consequences of investment in QOFs is whether investors would be subject to depreciation recapture upon interests in a QOF holding properties that have been depreciated during the 10 year holding period. If so, then the tax benefit to investors would be significantly diminished. The proposed regulations do not specifically mention “depreciation recapture,” but they do state that once an investor completes his or her 10 holding period of the QOF investment, the investor receives a step-up in basis of the investment to the fair market value of the assets held by the QOF, so that when the investor sells his or her interest in the QOF, there would be no recognition of income or capital gain as a result of the sale.

However, the proposed regulations do not yet address this issue with respect to a sale of property by the QOF, because the regulations only allow investors in the QOF to elect to defer their capital gain, not ordinary income as a result of the sale. It is assumed that this distortion will also be corrected by the IRS in the future, since there would be no reason for a different tax outcome if the investor sold his or her interest in the QOF as opposed to making an election to defer tax upon a sale of QOZP by the QOF.
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