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Set forth below are some key takeaways from the second tranche of Opportunity Zone proposed regulations issued on Wednesday, April 17 by the IRS.

This new set of proposed regulations: (a) liberalizes the time frame for deployment of capital by a QOF, (b) potentially expands exit strategy alternatives by providing rules regarding the treatment to QOF investors in the context of dispositions by QOFs of their investments after the investor's 10-year hold period (including the receipt of capital gain dividends by investors in REITs that are QOFs), (c) provides rules regarding dispositions and reinvestments by QOFs that, while welcome, are not helpful for QOFs organized as passthrough entities, (d) addresses the treatment of carried interests and other mixed investments in QOFs, (e) establishes tests to determine when businesses are treated as conducted within an opportunity zone, and (f) clarifies some concepts, including the definition of "original use" and "substantially all" and the treatment of leased (rather than purchased) property, and what constitutes the "active conduct of a trade or business." In addition to these issues, other issues are addressed, including technical issues around investor basis inclusions, transactions that trigger deferred gain inclusion, dealing with property that is partly located in an opportunity zone, coordination (or lack thereof) with the consolidated return rules and other items.

The notice of proposed rulemaking that accompanied these new regulations confirmed that a third tranche of Opportunity Zone proposed regulations would be forthcoming; these proposed regulations are intended to address penalties for QOFs that fail the 90% "good asset" test and address QOF and QOZ subsidiary reporting obligations.

My Firm will issue a comprehensive client alert on this second tranche of Opportunity Zone proposed regulations in the coming days. In the interim, the point of this email is to address certain key concepts addressed in these proposed regulations that I think are of greatest interest to this audience.

1. Cash Deployment Rules Further Liberalized: The new proposed regulations continue the liberalization trend for capital deployment initiated by the October 2018 proposed regulations in two ways. First, at the QOF level, for purposes of its (otherwise stringent) biannual 90% "good" asset test (in which cash generally does not count as a "good" asset), the new proposed regulations provide that investments received during the preceding six months are ignored as long as they are continuously held in cash, cash equivalents or debt instruments with a term of 18 months or less. Second, with respect to the 31-month "working capital on-ramp" safe harbor created for QOF subsidiaries in the October 2018 proposed regulations, the new proposed regulations provide that exceeding the 31-month deployment period does not violate the safe harbor if the delay is attributable to waiting for government action on an application which is itself filed during the 31-month period.

Taken together, these rules provide further relief to investment program sponsors who were concerned about (a) having to artificially time the intake of investments into a QOF to avoid failing the 90% "good" asset test, and (b) failure to adhere to the 31-month working capital safe harbor due to chronically unpredictable government action.

2. Exit Strategies No Longer Limited to Sales of Interests in QOFs -- Sort Of: A key practical limitation of the Opportunity Zone structure has been dealing with how investors exit a QOF investment in a tax efficient manner after a 10+ year holding period. Prior to the new proposed regulations, it appeared that the only way for an investor to achieve the FMV basis step-up tax benefit from exiting a QOF investment held for 10 or more years was to sell its interest in the QOF. The prospect of such a requirement caused significant consternation, since QOFs were almost entirely being structured to operate through subsidiaries, and given further that buyers generally prefer asset acquisitions to ownership interest acquisitions.

The new proposed regulations partially address this structural deficiency by permitting direct owners of QOFs structured as partnerships and S corporations to make an election to exclude from their gross income some or all of the capital gain arising from the QOF's disposition of opportunity zone property, provided that the gains arise after the owner's 10-year holding period. Such excluded gains are added to an investor's basis in the QOF investment, thereby ensuring that the investor isn't later taxed on the disposition or liquidation of the QOF interest. Similar rules are provided with respect to certain REIT dividends that satisfy certain dating and notice requirements.

While helpful, these rules don't appear to completely treat dispositions of QOF interests and dispositions of assets by QOFs identically. The new proposed regulations clarify that in the disposition of an interest in a QOF partnership held for more than 10 years, the basis step-up applies to ordinary income elements (e.g., embedded accounts receivable, inventory and depreciation recapture) as well as capital gain elements. However, the direct owner election applies to eliminate only capital gains, and not any associated ordinary income items that may attend a disposition. As a result, however impractical, QOF interest dispositions may still be favored for tax planning purposes. Comments on these rules have been invited.

3. Dispositions and Reinvestments by QOFs; Looks Like One Step Forward, but is Really One Step to Nowhere for Passthrough QOFs: Code Section 1400Z-2(e)(4)(B) authorized the issuance of rules that would allow a QOF to dispose of QOZ property and reinvest in other QOZ property in a reasonable time frame. The new proposed regulations helpfully provide a QOF with a 12-month window in which to reinvest the proceeds from a QOZ asset disposition so long as those proceeds are held in cash, cash equivalents or debt instruments with a term of 18 months or less.

While this rule certainly helps QOFs avoid qualification failure risk (that could otherwise arise from holding cash for an extended period of time), the notice of proposed rulemaking that accompanied the proposed regulations expressly disclaimed any ability to favorably address passthrough QOF investor negative consequences that would arise by reason of such a transaction, and solicited comments on the topic. So, while the new proposed regulations allowing for QOF dispositions and reinvestments are welcome, for pass-through QOFs they are meaningless in the absence of rules providing protections in reinvestment situations to QOF investors.

4. No Favorable QOZ Investment Treatment for Carried Interests: The new proposed regulations provided rules regarding "mixed investments," which for this purpose are investments in a QOF by an investor consisting of both qualified deferred gains and other items. In sum, although general principals of tax law require a partnership interest to be treated as a single interest, "mixed investments" are nonetheless treated, solely for QOZ rule purposes, as being comprised of two investments -- one consisting of qualified deferred gain, and the other consisting of all other elements of the interest. Among other things, these rules make clear that carried interests (interests received for services) are not entitled to favorable QOZ tax treatment, and that an investment

comprised of a QOZ deferred gain capital element and carried interest element will be treated as a mixed investment. Moreover, and significantly, on the issue of relative allocation percentages with respect to a mixed investment consisting of a capital and a carried interest element, the new proposed regulations provide allocations are made (a) with respect to the carried interest, the highest percentage interest in residual profits to which the interest is entitled, and (b) with respect to the remaining interest, the relative proportion of capital contributions represented by the remaining interest.

5. What It Means to Conduct Business in an Opportunity Zone: In order for a business to qualify as a QOZ business, Code Section 1400Z-2(d)(3)(A)(ii) requires (by cross reference to Code Section 1397C(b)(2)) that 50% of its gross income be earned from the active conduct of a trade or business in an opportunity zone. While this requirement appears to be easy to satisfy for a trade or business involving the ownership and operation of real estate (as its income is derived from real estate located in an opportunity zone), its application was less clear to non-real estate trades or businesses.

The new proposed regulations significantly clarify this rule by providing three alternative safe harbors and a separate facts and circumstances test for determining where a trade or business is conducted.

- Safe Harbor 1 -- Satisfied if at least 50% of services performed (based on hours of service) by employees and independent contractors are performed in an opportunity zone.

- Safe Harbor 2 -- Satisfied if at least 50% of compensation paid to employees and independent contractors are paid for services rendered in an opportunity zone.

- Safe Harbor 3 -- Satisfied if the tangible property of the business and the management or operational functions of the business that are conducted in an opportunity zone are necessary to generate at least 50% of the gross income of the business.

- Facts and Circumstances -- if none of these three safe harbors apply, the 50% gross income requirement may be met if, based on the facts and circumstances, at least 50% of the gross income of the business is derived from the active conduct of a trade or business in an opportunity zone.

6. Some Concepts Clarified: Several key elements of the QOZ rules have hinged on undefined terms or concepts, such as the definition of "substantially all" (except solely for its use in the amount of tangible property of a QOZ subsidiary that is required to be QOZ business property (70% per the October 2018 proposed regulations), the treatment of leased (as opposed to purchased) property, the meaning of "active conduct of a trade or business" in the context of the activity level required of a QOZ business. Among these clarifications are the following:

- *Substantially all* -- With respect to holding period determinations, "substantially all" has been defined as 90%, but with respect to the use of property, a 70% standard has been adopted. So, for example, with these definitions, Code Section 1400Z-2(d)(2)(D)(i)(III) (relating to the definition of QOZ business property) would read "during 90% of the qualified opportunity fund's holding period for such property, 70% of the use of such property was in a qualified opportunity zone."

- *Original use* -- A few clarifications were provided: (a) "original use" of tangible property occurs when the QOF or any prior owner of the property puts the property into use in the qualified opportunity zone if used in a manner that would allow the property to be subject to depreciation or amortization; (b) QOZ vacant preexisting structures can qualify for "original use" only if they have been vacant for at least 5 years; (c)

tenant improvements acquired for property upgrades are generally treated as subject to the "original use" rule; and (d) consistent with the October 2018 proposed regulations, although the original use rule doesn't apply to land, and land doesn't need to be substantially improved. However, land must be used in a trade or business, and an anti-abuse rule will be deployed if needed to combat pure land plays run through QOFs.

- *Leased Property* -- The new proposed regulations clarify that leased tangible property is treated like purchased tangible property for QOZ qualification purposes. Surprisingly, unlike the rule for purchased property, leased property does not need to be leased from an unrelated party. However, any related party leased property (a) must be leased at market rate rents (determined under Section 482 transfer pricing principles), (b) no prepayments of rent in excess of 12 months are permitted, and (c) the lessee must purchase and own tangle property that equals or exceeds the value (as determined below) the related party leased property, which property must be acquired within 30 months of the date on which the leased property comes into possession, and the location of use of the properties must substantially overlap.

- *Active Conduct of a Trade or Business* -- As noted above with the business tests, Code Section 1400Z-2(d)(3)(A)(ii) requires (by cross reference to Code Section 1397C(b)(2)) that 50% of the gross income of a QOZ business be earned from the active conduct of a trade or business. The new proposed regulations clarify that "trade or business" is determined by reference to longstanding principles under Code Section 162. They further indicate that "the ownership and operation (including leasing) of real property is the active conduct of a trade or business" but specify that "merely entering into a triple-net-lease with respect to real property owned by the taxpayer is not the active conduct of a trade or business by such taxpayer."

As I indicated above, the new proposed regulations cover many more topics, and my Firm intends to issue a comprehensive client alert on the new proposed regulations in the coming days. In addition, it is possible that our views on the topics addressed above may evolve. However, we believe this summary addresses some key issues of interest to your involvement in QOZs and I hope you find it helpful.

Best regards,
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