Regulations Update

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Introduction to Treasury Guidance

1. Kinds of Guidance - Rev Ruls, one round of proposed regulations, frequently asked questions, and IRS forms and instructions. Note that they aren't necessarily consistent or comprehensive.

2. Rules for issuing Treasury guidance:

    a. Timing and approval process. Working with OMB. process.

    b. Unclear if OZ regulations will be finalized all at once, or periodically.

3. What to expect in Tranche 2? -- [Much more detail below] -- Computing Gross Income, Distributions of refinance proceeds. What does it take to substantially improve the property, how to handle leased property, how to develop used property, roll-overs of gains from sales *inside* the fund, tax treatment of carried interests and promotes, tax consequences of depreciation recapture after 10-year holding period.

4. What to expect in Tranche 3? -- Anti-abuse, decertification, tax reporting

Hot Topics

(1) **Active trade or business in the Zone**. The issues: What is "active"? What does "in the zone mean"? Will that provision be in subsequent versions of the regulations?

In the zone. Different possible methodologies: measured gross income, head count, based on payroll and contractors. Where was the value created? Can we expect safe harbors and examples?

Active. What about the many suggestions to IRS of having revenue within 3 years?

What other rules might apply? Section 183 rules? (They'd allow something run LIKE a business, even if it doesn't have income.) Compare the passive activity rules, where leasing is per se passive.

What about a leasing office? Does the fund/subsidiary entity have to actually manage the property, or can it hire someone? The foreign tax credit rules seem to require the taxpayer to actually manage. What about triple net leases?

Is residential rental property an active trade or business?

(2) **<u>Comparing the "90% of all assets must be QOZP test for funds" with the "70% of tangible assets must be QOZBP" test for subsidiary entities</u>**.

Can you really have a business in a subsidiary that has $100,000 of in-the-zone, new computers (and nothing else) and $5M of intangible software, and say, "Well, 100% of my assets are in the zone, so I pass the test!" Remember that a substantial portion of the intangibles must be used in the zone.

Might the IRS adopt tests similar to the NMTC rules and apply a higher than 70 percent standard for real estate? What might that mean for leased renewables?

(3) **<u>31-month written plans</u>**. How long, how detailed, does all the money have to be readily accessible now, or can it be reasonably expected? Can you have serial plans (e.g., 2 times 31 months?). Can this rule apply to business ventures? Can you invest in another partnership when it is within 31-months of PIS, and benefit from its prior work? Can a fund (as opposed to a subsidiary entity) use a written plan? What is a "safe harbor" anyway?

(4) **<u>The 6-month periods for testing 90%.</u>** The proposed regulations make the testing date the end of the year if the fund's first year starts with less than 6 months to go. Will the IRS really stick to a regulation that gives you less than 6-months to pass the test if you form the Fund in the second half of the year? Similarly, what about chopping off partial months in the first year? This seems to violate the clear intention of the Code provision. There have been suggestions that the IRS was trying to make computations easier for taxpayers, but shouldn't that have been done by a voluntary election?

(5) **<u>Computing the value of your assets using the methodologies specified in the Regs.</u>** They can be a combination of onerous and misleading!

(6) **<u>Flips and other variations</u>**. About all the regs say is that you can have common and preferred. What about all the other techniques? Can the parties agree that they will share in residuals in a different ratio than capital? How different? Is this entirely based on appraisals?

(7) **<u>And what about compensation</u>**? Suppose a service provider puts up capital gain funds and gets a higher percentage interest (or a higher residual interest) on a per dollar basis than the "conventional" investor. Will that be respected as an investment in a Fund that is eligible for favorable treatment?

Can a service provider take advantage of the common promote strategies used by fund managers? Fundamental question – did they pay FMV for their interest, or is it simply that the value of their interest is not ascertainable? Can they make the argument that future appreciation is considered just that, and not received something received for services? If you are going to use a flip, how much? (Is 1% to 30% permitted? How about .01% to .90%? Is .01% to 30% okay? Would an appraisal help? There's lots of law that *might* apply here: case law: *Diamond, Campbell, Pacheco.* Compare determinable with speculative value. Section 83, Section 721(a). Rev Proc. 93-27 provides for a tax consequence where there is a "substantially certain stream of income," a disposition within 2 years, or the partnership is publicly traded. And, there's a safe harbor election for 0 liquidation value in the Section 83 proposed regulations. Finally, new Section 1061 would set a three-year holding period for a service provider to get LTCG treatment.

Might there be an election to treat a service-related investment in a QOF as consisting of part-cash, part-property, and part-services?

(8) **<u>Distributing refinancing proceeds</u>**? Is there anything to rely on in distributing extra money? Indeed, CAN a fund hold onto "excess cash" without blowing the 5% NQFP or 90% tests that apply to subsidiary entities and Funds, respectively? How soon after an investment/refinancing can it make distributions? How might distribution compare to the fair market value of the investment? Can the taxpayer reduce the value of its interest (and therefore its tax bill) by doing a refinance in 2026 and distributing the proceeds?

(9) **<u>The more than 100% of basis rehab test</u>**. Can you count expenditures in new assets if they are "with respect to" the used assets even if they are entirely new, with no improvement? Example: Old residential building cost $500. Can you spend $500 on an adjacent grocery store, etc., and say that the second expenditure is "with respect to" the first? Or does each asset get evaluated on its own? Or as a group? Can the 70% test include pre-2017 asset values as "bad" but not excluded assets? Can the Fund count expenditures that don't pass the rehab test as "separate assets", kind of like the historic credit? Examples: $300 old asset. Can a $700 new expenditure work, by passing the 70% test, as opposed to the 100% rehab test? Does it have to include *some* work on the old asset? E.g.,

$50 spent on the $300 old asset and $650 on new assets? Furthermore, does the $50 count if it isn't enough to make the old asset 100% rehabbed?

(10) **<u>What about Leased Property</u>**? Can a fund lease property as a way to limit the impact of the 70%/90% tests, say with pre-2018 property that would otherwise fail to qualify? What about the rehab test? Does leasing take it out of the computation? The statute refers to "in which substantially all of the tangible property owned *or leased* by the taxpayer is qualified opportunity zone business property."

(11) **<u>What about gains and other tax items *inside* the fund</u>**? Does the fund elect on behalf of investors to rollover gains? What will the rollover period be? Will the gain be recognized? Does it restart the 10-year period? What the 5-year and 7-year step-ups? Can they be used against suspended losses? Then, what happens in 2026? Example: A has no basis to use depreciation allocated to him in years 1-4. When he gets the 10% and 5% basis step-ups, does he use them to deduct some of the suspended losses? If he does, does he now recognize the whole capital gain in 2026?

(12) **<u>Will Treasury allow a wind down exit period for an orderly liquidation, as opposed to straight sale of QOF interest</u>**? Remember: the no-tax-after-ten-years applies to a sale of the interest in the fund, ***not*** the assets of the fund.

(13) **<u>What about 1245/1250 Depreciation Recapture on a post-10 year sale of a Fund interest</u>**? On the one hand, depreciation recapture transcends other gains. On the other, if you don't have a gain, do you have depreciation recapture? How does 1245 (personal property) compare to 1250 (real estate)?

(14) **<u>How is the penalty computed</u>**? Is it Really based on gross? Or Net? How is the rate computed?