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The Wizard of OZ – (that's "Opportunity Zones") Dorothy still has some questions - by Dan Flanigan

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The previous two articles (published December 19th and January 7th) discussed some important issues that the U.S. Treasury resolved in its proposed regulations issued on October 19, 2018.1 I promised in the last column that my next one would discuss important unanswered questions where additional Treasury guidance would be welcome if not essential. There are several important ones. Here are some of the most important.

Cash-Out Financing/Return Of Capital From Operating Profit Distributions

Capital gains invested in opportunity zones are required to remain at risk for 10 years. Traditionally, real estate investors can extract invested capital and even profits tax-free in properly structured financing transactions before the ultimate sale of the property. Will qualified opportunity funds (QOFs) or qualified opportunity zone businesses (QOZBs) be allowed to refinance their portfolio properties before expiration of the 10-year period and distribute the proceeds to investors without jeopardizing opportunity zone benefits?

The answer is unclear today. If investors in effect extract all or part of their equity investments when the project refinances or obtains additional financing, the IRS may argue that the investors have withdrawn their investments or converted their equity investments to debt. Thus, the IRS could deny investors Opportunity Zone benefits and try to tax the invested deferred capital gains at that time. The proposed regulations expressly allow investors to use their equity in a fund as collateral for a loan, which would achieve the same result. It does not seem to make sense to allow investors to do this individually but deny the same opportunity to the fund itself, especially since financing of hard assets, not equity interests, is the norm in the real estate world.

If a QOF or QOZB cannot return equity with financing proceeds, can it do so with operating profits from the investment? This issue is too complicated for extended discussion here, but it is critical, as its resolution may significantly affect the overall after-tax return of investors.

Active Conduct Of Trade Or Business: Sales Outside The Zone

The proposed regulations mandate that at least 50% of the gross income of a QOZB must derive from the active conduct of a trade or business "in the qualified Opportunity Zone." The proposed regulations added the words within quotation marks; although perhaps intended to clarify an ambiguity, the language created or exacerbated others, including these—

What about sales of goods or services to customers outside the zone?

If Treasury follows international tax “source of income” rules, which may be analogous, performing services from an office in the Opportunity Zone should qualify, regardless of where customers are physically located. The source of income for the performance of services is where the services are performed.

Concerning the sale of goods, the rule is that the income source is generally where the goods are manufactured. Based on this rule, if adopted by final Opportunity Zone regulations, sales of goods outside the zone that are manufactured inside the zone should qualify, especially if no sales activities occur outside the zone (or, possibly, if they are undertaken on a commission basis by distributors). But what if some sales activities do occur outside the Opportunity Zone? The same international tax rules indicate that soliciting orders, advertising, and even broadcasting radio advertisements into an area can constitute conducting business in that area.

More broadly, what about a business that establishes itself initially in the Opportunity Zone but then branches out from there, perhaps developing many operations outside the zone but keeping its headquarters there? Will all those satellite operations need to be established as separate entities, requiring complex intercompany contractual arrangements and accounting? If so, will the IRS accept that solution or, instead, assert a “substance over form” argument to vitiate it?

There will likely be many more issues generated by the “active conduct” requirement in the context of successful and growing businesses. Hopefully, Treasury will establish a generous and flexible framework for dealing with these questions as they arise. Once again, the issue is whether a miserly approach will inhibit the inflow of operating businesses into the Opportunity Zones or result in a premature exit once it appears that the business has trapped itself in an iron cage (hats off to Max Weber).

Interim Gain Issue: Sale By Fund Before 10 Years Followed By Qualified Reinvestment Of Sale Proceeds

The statute and current regulations allow an investor to sell its complete interest in a QOZF and reinvest the proceeds in another qualified investment within 180 days without recognizing gain (although it is not clear whether the investors’ 10-year holding period restarts). However, neither the statute nor the proposed regulations indicate whether a fund or QOZB can, in a similar vein, sell Opportunity Zone business property (or whether a fund can sell the stock or membership interest in a QOZB), and reinvest the proceeds without paying tax on any gain. The statute and proposed regulations do state that a fund should have a reasonable time to reinvest the proceeds without violating the 90% asset test but are silent on this “interim gain” issue. The resolution will have significant consequences since investors, once the investment is stabilized, often will want to “cash in” their winnings and redeploy into the next project rather than waiting out the 10 years.

Generally, Will We Be Burdened By Having To Sell Equity Interests, Not The Real Estate Or Other

Assets Themselves To Qualify For Various Benefits?

Throughout the statute an arguably artificial distinction is made between the sale or pledge of QOF stock or a partnership interest vs. the sale or mortgaging of real estate or other assets held by the QOF or a QOZB. The statute provides that the 10-year exemption from tax is only realized when an investor sells the investment in the QOF, and not when the QOF sells its property or investment in a QOZB. Why should the investors, in order to qualify for the tax exemption after 10 years, be required to sell QOF stock or partnership interests rather than cause their QOFs to sell the underlying assets, especially when the sale of an equity interest rather than a direct asset sale generally both limits the pool of interested buyers and the amount those buyers are willing to pay given that they must assume existing liabilities in an equity purchase. Since it does not serve a legitimate policy purpose but undermines the legislative goals, perhaps the Treasury will eliminate this artificial distinction.

These and other questions cry out for answers as soon as possible. But as of this writing, on the 18th day of the government shutdown, the hallways and offices of the U.S. Treasury are dark and the pencils are down. No, Dorothy, we’re not in Kansas anymore.

Thanks again to the real wizards, my tax-lawyer colleagues Jeff Goldman of our Chicago office and Pat O’Bryan of our Kansas City office, for their help in developing this article.

1 This article assumes readers’ knowledge of the basic Opportunity Zone statutory provisions. For a summary of the basic provisions, please see polsinelli.com/intelligence/oz-ppt.

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