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The Second Set of Proposed Opportunity Zone Regulations: Where Are We Now?

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INTRODUCTION

On April 17, 2019, Treasury issued a highly anticipated second set of proposed regulations on opportunity zones (REG-120186-18, the ''2019 proposed regulations''). The opportunity zone (OZ) program has received significant national attention as an ambitious and generous tax incentive aimed at driving investment into the nation's most distressed communities.

Although various forms of tax incentives have been available for years with respect to the economic development of low-income communities (e.g., LIHTC, NMTC, Enterprise Zones, etc.), there are many who believe that this program is the key to unlocking billions, perhaps trillions, of private capital, incentivizing its move into opportunity zone projects. Funds are being created and capital is being raised but much of that capital has been sitting on the sidelines waiting for a sufficient level of regulatory certainty around the rules. This has been particularly true in the context of capital waiting to be deployed into operating businesses in opportunity zones. The open issues, have, in many cases, made investment too risky.

This newest set of regulations brings **much-needed clarity to critical questions** with respect to the OZ program. The 2019 proposed regulations address a number of issues, including but not limited to:

- Allowable qualifying investments in qualified opportunity funds (QOFs);
- The relevant definitions of ''substantially all;''
- The original use and substantial improvement tests;
- Transactions that may trigger inclusion of previously deferred gain and the amount and timing of that gain;
- The treatment and valuation of leased property;
- The sourcing of income for purposes of the 50% of gross income test applicable to qualified opportunity zone businesses; and
- The definition of a ''reasonable period'' within which a fund may re-invest proceeds from the sale of an asset.

It is clear from these regulations that the government is trying to incentivize investment by broadening the tests and providing flexibility to investors with respect to the types of investments and projects that qualify.

As discussed more fully below, there is at least one provision, however, that was much needed and was not included—a provision that would allow funds to sell assets without recognizing gain. This is a significant remaining issue and may require legislative action.

Quite significantly and similar to the first set of regulations, taxpayers are generally allowed to rely on most of this newest guidance in spite of the fact that it is merely proposed.

On October 19, 2018, the IRS issued a first set of proposed regulations on opportunity zones (REG-115420-18, the ''2018 proposed regulations''). The IRS contemporaneously issued Rev. Rul. 2018-29 that addressed the application of the original use and substantial improvement tests to the purchase of land with an existing building in an opportunity zone as well as a draft QOF self-certification form (Form 8996) and accompanying instructions.

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Not surprisingly, the first set of proposed regulations left many unanswered questions with respect to the statutory language and the regulations themselves (along with the revenue ruling) created additional uncertainties. The IRS requested comments on a number of issues addressed in the 2018 proposed regulations. The IRS received a significant number of comment letters on the regulations, including extensive comments from the ABA Tax Section and the NYSBA Tax Section, and held a hearing on the 2018 proposed regulations on February 14, 2019. The 2019 proposed regulations do make some changes to the 2018 proposed regulations.

As helpful as it is to have additional guidance, there are still unanswered questions with respect to the opportunity zone rules – some of which relate to issues that have been initially addressed in regulations and some of which have not yet been tackled in regulatory guidance. In addition, as we analyze and apply this second set of proposed regulations there is no doubt that additional uncertainty will arise with respect to the guidance in these regulations.

The IRS is aware of the fact that not all of the questions inherent in this new program have been answered but they have indicated that other than issuing these two sets of regulations in final form, they may not issue another round of proposed regulations. They have stated that they plan to address administrative rules related to a qualified opportunity fund's failure to comply with the program and a set of information reporting requirements.

Although we may not have fully fleshed out final rules on opportunity zones for quite some time, there is enough guidance available at this point for investors to structure transactions with a sufficient level of certainty that they meet the opportunity zone requirements.

This article assumes a basic knowledge of the opportunity zone rules as well as an understanding of the 2018 proposed regulations and focuses on the questions addressed in the recently issued second set of proposed regulations as well as the questions that remain unanswered.

This article does not cover every regulatory provision. In particular, with respect to the rules related to the computation of amounts invested in a QOF as well as inclusion events, the article focuses on QOF partnerships and Subchapter K rules.

TEN KEY TAKEAWAYS FROM THE 2019 PROPOSED REGULATIONS

- The regulations provide much-needed guidance on investment in operating businesses; the income sourcing rules are generous and should be sufficient to qualify a number of different types of businesses; the working capital safe harbor has been extended to include the development of a trade or business.
- A taxpayer is able to invest cash or other property in a QOF.
- There is no substantial improvement test applicable to the purchase of unimproved land but the land has to be used in the active conduct of a trade or business; in addition a taxpayer is not allowed to rely on this rule if the land is unimproved or minimally improved and the QOF or qualified opportunity zone business (QOZB) purchased the land with an expectation, an intention, or a view not to improve the land more than an insubstantial amount within 30 months of the date of purchase.
- If a building has been **vacant for five years** it is able to qualify as original use property (does not need to be substantially improved)
- Subject to an anti-abuse rule applicable to all leases, leased property is qualified opportunity zone business property (QOZBP) as long as the lease is entered into after December 31, 2017, the terms of the lease are market-rate, and during substantially all of the QOF's holding period for the property, substantially all of the use of the property was in a QOZ.
- There is no prohibition on related party leases but these leases have to meet certain additional requirements.
- There was a lot of concern that the 31-month period in the first set of regulations would not be sufficient, especially in the context of projects that require extensive permitting and other types of governmental approvals. These regulations address that concern and allow for delays that are attributable to waiting periods for government action.
- The regulations generally allow a QOF partnership to make debt-financed distributions, subject to two limitations: first, if the investor has remaining deferred gain from a qualifying investment in the QOF, a distribution to that investor will trigger inclusion of that gain to the extent that the distribution exceeds the investor's basis (which will include the investor's share of QOF liabilities); in addition, if an investor receives a distribution from the QOF within the first two years of an investor's contribution of cash or other property to the QOF, there are rules that could apply to re-characterize that original contribution as a non-qualifying investment (not subject to the OZ benefits).

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- The regulations provide guidance on how a fund is able to reinvest proceeds resulting from a return of capital event or the sale or other disposition of QOZP. As long as the proceeds are reinvested in QOZP within 12 months, the proceeds are treated as qualified property. Unfortunately for investors, however, the regulations do not include a provision that would allow a QOF to sell assets without recognizing gain, so the sale is a taxable event; Treasury and the IRS did not feel that the statute gave them authority to provide for nonrecognition of gain. This is a significant remaining issue and may require legislative action.
- An investor who has held its QOF interest for at least 10 years is able to elect to exclude capital gain from gross income if that gain is reported on a K-1 from a QOF partnership or S corporation and is attributable to the QOF's sale of QOZP; this rule goes a long way toward solving the exit issue that existed with respect to QOF partnerships and S corporations.

QUESTIONS THAT THE 2019 PROPOSED REGULATIONS ADDRESS

Note that the 2018 proposed regulations defined an ''eligible interest'' as an equity interest issued by a QOF. The term ''eligible interest'' does not refer to an interest to which the OZ tax benefits apply. The 2019 proposed regulations provide that an eligible interest with respect to which a deferral election applies is a ''qualifying investment'' (an investment to which the OZ benefits apply). These regulations also refer to an interest in a QOF to which the OZ tax benefits apply as a ''Section 1400Z-2(a)(1)(A) interest'' in contrast to a ''Section 1400Z-2(e)(1)(a)(ii) interest,'' which is an interest in a QOF to which the OZ benefits do not apply.

This article refers to an interest in a QOF to which the OZ tax benefits apply as a qualifying investment and a QOF interest to which the OZ tax benefits do not apply as a non-qualifying investment.

General Anti-Abuse Rule

What is the general anti-abuse rule applicable to OZ investments?

The 2019 proposed regulations add a general anti-abuse rule that requires the statutory and regulatory OZ rules to be applied in a manner consistent with the purposes of those rules. If a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of the OZ rules (based on all of the facts and circumstances), the Commissioner is able to recast the transaction (or series of transactions) for federal tax purposes in a manner that achieves tax results consistent with those purposes.

The Preamble to the 2019 proposed regulations describes the purposes of the OZ rules as follows:

> Sections 1400Z-1 and 1400Z-2 seek to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing Federal income tax benefits to taxpayers who invest new capital in businesses located within qualified opportunity zones through a QOF.

This general anti-abuse rule makes it clear that first and foremost, investment in an OZ needs to be structured in a way that comports with the intent of the program. As an example, there has been a lot of commentary regarding potential abuse of the holding in Rev. Rul. 2018-29. That ruling provides that if a taxpayer purchases land and an existing building, the land itself does not have to be separately ''improved'' and the basis in the land is not part of the basis that needs to be doubled in order to meet the substantial improvement test for the building. There are certainly facts and circumstances in which the revenue ruling can be applied in a way that could be considered abusive. What if a taxpayer purchases land and an existing building for $4 million but $3.9 million is allocated to the land because it is a large, valuable tract and the ''building'' is a two-car garage on the edge of the land? What if the taxpayer spends another $100,000 to expand the garage? Technically, the taxpayer meets the requirements of the revenue ruling but it certainly seems counter to the intent behind the ruling as well as the intent behind the OZ program to allow this transaction to qualify. Of course, this is an extreme example and in this instance the taxpayer may well not meet the active trade or business requirement. However, the point is that the revenue ruling leaves open the important issue of the **ratio** of the value of the existing building to the land and whether there should be some minimum ratio required in order to apply the revenue ruling.

In navigating this issue and many of the other outstanding questions and issues that remain, the general anti-abuse rule should be considered and used as a general guideline.

Qualified Opportunity Fund (QOF) Investments

How do the OZ rules apply to the deferral of §1231 gain?

Under the 2019 proposed regulations, the only §1231 gain that is eligible for deferral through investment in a QOF is capital gain net income.

Section 1231 applies to gains and losses on the sale or exchange of, among other things, non-inventory

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depreciable property and real property used in a trade or business and held for more than one year. If §1231 gains for the taxable year exceed §1231 losses for the taxable year, the net gains are treated as long-term capital gains, subject to a recapture rule. If §1231 losses exceed §1231 gains for the year, the net loss is treated as an ordinary loss. The proposed regulations provide that with respect to gain that arises from §1231 property, only capital gain net income can be deferred and the 180-day period for investment into a QOF begins on the last day of the taxable year.

Note that this rule treats §1231 items in a less favorable manner than other capital gains and losses, where the rules generally allow a taxpayer to defer gross capital gain, and carry forward capital losses.

Can a member of a consolidated group invest and defer gain that was realized by another member of the group?

No. The 2019 proposed regulations provide that the OZ rules apply separately to each member of a consolidated group. Thus, the same member of the group must realize the capital gain to be deferred and invest some or all of that gain in a QOF to qualify for the OZ tax benefits.

Is a taxpayer able to make a qualifying investment in a QOF by transferring property other than cash to the QOF?

Yes. A taxpayer can make a qualifying investment by transferring **cash or other property** to a QOF in exchange for an eligible interest (an equity interest) and this rule applies regardless of whether the transfer is a recognition or nonrecognition event. That is, a taxpayer could transfer the property to a QOF in a taxable transaction (e.g., a transfer to a QOF corporation as to which §351 does not apply) or a nontaxable transaction (e.g., a contribution to a partnership to which §721(a) applies) in exchange for an eligible interest.

If a taxpayer receives an eligible interest in a QOF in exchange for property other than cash, what is the amount of the taxpayer's qualifying investment?

The answer to this question depends upon whether a taxpayer transfers property to a QOF in a carryover basis transaction (in whole or in part) or a taxable transaction. There are also special rules that apply when property is transferred to a QOF partnership.

Carryover Basis Transaction (Nonrecognition Transaction):

If property is transferred in a carryover basis transaction (e.g., a contribution to a QOF partnership under §721(a)), the amount of the taxpayer's qualifying investment for deferral purposes is equal to the lesser of (1) the taxpayer's basis in the QOF investment without regard to the special zero basis rule in §1400Z-2(b)(2)(B) or (2) the fair market value of the eligible interest received, both determined immediately after the contribution. This rule is applied separately to each piece of property contributed to the QOF. The taxpayer's initial basis in the qualifying investment is zero (which preserves the deferred gain that is being deferred under the OZ rules).

If a taxpayer has realized gain to defer through investment in a QOF and contributes built-in gain property in exchange for a QOF interest equal to the fair market value of the contributed property, the taxpayer will end up with a mixed-funds investment (a qualifying investment and a non-qualifying investment).

Note: The language in the regulations with respect to the calculation of the amount of the non-qualifying investment (specifically Reg. §1400Z2-(1)(b)(10)(i)(B)(*2*)) appears to be inaccurate. The regulations provide that the amount of a taxpayer's non-qualifying investment when the fair market value of the eligible interest received exceeds the taxpayer's adjusted basis in that interest (without regard to the zero basis rule) is equal to the excess of the "fair market value of the investment to which §1400Z2-2(e)(1)(A)(i) applies over the taxpayer's adjusted basis therein, determined without regard to section 1400Z-2(b)(2)(B)." The "investment to which §1400Z2-2(e)(1)(A)(i) applies" is the qualifying investment—this language would have you compute the difference between the fair market value of the taxpayer's qualifying investment and the adjusted basis in that investment without the zero basis rule. That does not get you to the right place. The non-qualifying investment should be equal to the excess of the fair market value of the eligible interest received over the taxpayer's adjusted basis in the interest without regard to the special zero basis rule in §1400Z-2(b)(2)(B). In fact, this is the calculation used in Example 1 in the relevant section of the regulations. The calculation in the example does not match the language in Reg. §1400Z2-(1)(b)(10)(i)(B)(*2*).

The taxpayer's basis in the non-qualifying investment is equal to the taxpayer's basis in all QOF interests received without regard to the §1400Z-2(b)(2)(B) zero basis rule, reduced by the basis of the taxpayer's basis in the qualifying investment determined without regard to the §1400Z-2(b)(2)(B) zero basis rule. Thus, if the transaction is a carryover basis transaction in whole, the taxpayer's basis in the non-qualifying investment will also be zero (which is preserving the built-in gain that is not recognized on the contribution).

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Example: On January 15, 2019, Taxpayer A realizes $5 million of capital gain that it can defer through investment in a QOF. A also owns unencumbered Asset X with a fair market value of $10 million and an adjusted basis of $5 million. On June 1, 2019, A contributes Asset X to a QOF in exchange for an equity interest (an eligible interest) with a fair market value of $10 million. A's basis in the QOF interest, without regard to the zero basis rule in §1400Z-2 would be $5 million (a carryover basis). A's investment is treated as an investment with mixed funds (two separate investments). A's qualifying investment in the QOF (to which the OZ tax benefits apply) is $5 million. A's basis in the qualifying investment is zero under §1400Z-2(b)(2)(B)(i). A has a separate non-qualifying interest in the QOF equal to $5 million (the excess of the fair market value of the eligible QOF interest received ($10 million) over the taxpayer's basis in that interest without regard to the zero basis rule ($5 million). A's basis in the non-qualifying interest is zero (A's basis in all interests received without regard to the zero basis rule ($5 million) minus A's basis in the qualifying investment but for the zero basis rule ($5 million)).

Note: Note that the example above uses the language and calculations in the regulation Example and not in the regulation text to compute the non-qualifying investment. If the language in Reg. §1400Z2-(1)(b)(10)(i)(B)(*2*) is applied to this example, the non-qualifying investment is zero (the fair market value of the qualifying investment ($5 million) minus A's basis in that interest but for the zero basis rules ($5 million)). That is not the right result.

In all cases, the amount of the qualifying investment is limited to the amount of gain that can be deferred under the §1400Z-2(a)(1) election. So, if in the example above, A contributed Asset X to a QOF but only had $4 million of realized capital gain to defer through investment in a QOF, the qualifying investment in the QOF would be limited to $4 million. A would have a non-qualifying investment of $6 million with a basis of $1 million.

In addition, there is a special rule applicable to the transfer of built-in loss property in a transaction that is a nonrecognition transaction in whole or in part and to which §362 applies. In that case the taxpayer is deemed to have made a §362(e)(2)(C) election (related to the transfer of built-in losses in a §351 transaction).

Taxable Transaction:

If a taxpayer transfers property other than cash to a QOF in a taxable transaction, the amount of the qualifying investment in the QOF is the fair market value of the transferred property, determined immediately prior to the transfer. This rules applies separately to each piece of property transferred.

Example: On January 15, 2019, Taxpayer A realizes $10 million of capital gain that it can defer through investment in a QOF. A also owns unencumbered Asset X with a fair market value of $10 million and an adjusted basis of $5 million. On June 1, 2019, A transfers Asset X to a QOF in a fully taxable transaction in exchange for an equity interest (an eligible interest) with a fair market value of $10 million. A's qualifying investment in the QOF (to which the OZ tax benefits apply) is $10 million. A's basis in that interest is initially zero.

Note that in this circumstance the taxpayer is not allowed to defer the $5 million of gain recognized on the transfer of the property to the QOF in exchange for an interest in the QOF.

Transfer of Property to a QOF Partnership:

Assuming that a transfer of property to a QOF partnership is eligible for a deferral election (e.g., it is not treated as a sale under §707), the amount of a taxpayer's qualifying investment is the lesser of (1) the taxpayer's net basis (adjusted basis minus debt) in the property contributed, or (2) the net value (gross fair market value over debt) of the property contributed. The amount of the non-qualifying investment is the excess, if any, of the net value of the contribution over the amount treated as a qualifying investment.

The taxpayer's basis in the qualifying investment (prior to application of the zero basis rule in §1400Z-2(b)(2)(B)) is the net basis of the contributed property determined without regard to the zero basis rule or any share of debt under §752. The basis in the non-qualifying investment (without regard to any share of debt under §752) is the remaining net basis. After §1400Z-2(b)(2)(B) is applied to the qualifying investment, the taxpayer's basis in that interest will be zero, increased by the taxpayer's share of any debt allocated to that investment. The basis in the non-qualifying investment will also be increased by the taxpayer's share of debt allocated to that interest.

Note: The language in Reg. §1.1400Z2(a)-1(b)(10)(ii)(B)(*4*) could be easily misunderstood the way it is written. It states that a taxpayer's basis in the qualifying investment "**is** the net basis of the property contributed, determined without regard to section 1400Z-2(b)(2)(B) or any share of debt under section 752(a)." However, it is impor-

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tant to understand that this determination of basis is only relevant for purposes of determining the basis in the non-qualifying investment. Once the basis in the non-qualifying investment is determined, the taxpayer applies §1400Z-2(b)(2)(B) and takes an initial basis of zero in the qualifying interest, increased by any allocable share of debt under §752(a).

Example 1: On January 15, 2019, Taxpayer A realizes $5 million of capital gain that it can defer through investment in a QOF. A also owns unencumbered Asset X with a fair market value of $10 million and an adjusted basis of $5 million. On June 1, 2019, A contributes Asset X to a Partnership QOF in a transaction that is characterized as a contribution. The amount of A's qualifying investment is $5 million (the lesser of A's net basis in Asset X ($5 million) or the net value of Asset X ($10 million)). The non-qualifying investment is $5 million (the excess of net value ($10 million) over the qualifying investment ($5 million). For purposes of computing A's basis in the non-qualifying investment, A's basis in the qualifying investment is $5 million (net basis without regard to the zero basis rule). A's basis in the non-qualifying investment is zero (net basis remaining). A's basis in the qualifying investment after application of the zero basis rule is also zero.

Example 2: Assume the facts in Example 1 but also assume that Asset X is subject to $3 million of debt. A's qualifying investment is $2 million (the lesser of $2 million net basis ($5 million minus $3 million) or $7 million net value ($10 million minus $3 million)). A's nonqualifying investment is $5 million (excess of net value ($7 million) over amount treated as a qualifying investment ($2 million)). A's basis in the qualifying investment is zero. For purposes of computing A's basis in the non-qualifying investment, A's basis in the qualifying investment is $2 million (net basis without regard to the zero basis rule or §752(a)). A's basis, without regard to §752(a) in the non-qualifying interest is zero (remaining net basis). After application of §1400Z-2(b)(2)(B), A's basis in the qualifying investment, without regard to §752(a) is also zero. A will increase its basis in each interest by its allocable share of the debt under §752(a). A will allocate its share of the debt under §752(a) between the two investments based on the relative capital contributions attributable to each (2/7 and 5/7).

Example 3: Assume the facts in Example 1 but also assume that Asset X is subject to $6 million of debt. A's qualifying investment is zero (the lesser of zero net basis ($5 million minus $6 million, limited to zero) and $4 million net value ($10 million minus $6 million). The entire investment is a non-qualifying investment.

How do the §707 disguised sale rules apply in the context of an investment in a QOF partnership?

The 2019 proposed regulations provide the following two rules with respect to §707 (the disguised sale rules) and investments in QOF partnerships:

(1) First, if a contribution of property to a QOF partnership is characterized as something other than a contribution (e.g., a sale under the disguised sale rules), the transfer is not an investment eligible for the deferral election. This requires an analysis at the time of an investment of deferred gain in a QOF partnership to make certain the contribution is not a disguised sale under §707.

(2) Second, assume that a taxpayer makes a contribution of property to a QOF partnership that is an investment for which a deferral election is available. Assume further that the partnership makes a distribution to the partner. If the contribution and distribution would be treated as a disguised sale if (a) any cash contributed is treated as non-cash and (b) in the case of a debt-financed distribution, the partner's share of liabilities is zero, then the transfer to the partnership is not treated as an investment for which a deferral election could be made. In other words, upon any distribution from a QOF partnership, the distribute partner has to analyze its contribution to the partnership and the distribution under §707 rules applying the assumptions in (a) and (b) above. This is more fully discussed in the context of debt-financed distributions, below.

Is a taxpayer able to make a qualifying investment in a QOF by providing services to the QOF? That is, do the OZ benefits apply to a carried interest (profits interest received in exchange for services)?

No. The regulations provide that if a taxpayer receives an interest in a QOF in exchange for services that the taxpayer provides to the QOF or a person in which the QOF holds any direct or indirect equity interest, the interest is not a qualifying investment – that is, it is not an interest to which the OZ tax benefits apply. It is, instead, an investment under §1400Z-2(e)(1)(A)(ii). Thus, the OZ tax benefits do not apply to a carried interest in a QOF.

Is a taxpayer able to make a qualifying investment in a QOF by acquiring a QOF interest from someone other than the QOF?

Yes. A taxpayer is allowed to acquire an eligible interest in a QOF from another person for either cash or other property. The amount of the qualifying investment is the amount of cash, or the fair market value of the other property, as determined immediately be-

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fore the exchange, that the taxpayer transferred in exchange for the eligible QOF interest. The amount of the qualifying investment is limited to the amount of gain that can be deferred under the §1400Z-2(a)(1) election.

If a taxpayer transfers built-in gain property to an eligible taxpayer in exchange for an eligible interest in a QOF, any gain realized by the taxpayer on that transaction is not eligible for deferral through investment in a QOF.

What circumstances are treated as "inclusion events"—events that require a taxpayer to include in income gains that were previously deferred?

The 2019 proposed regulations provide a long list of ''inclusion events'' and a significant amount of guidance related to the various tax consequences of inclusion events. Inclusion events are relevant only until the taxpayer has included in income all of the gain deferred through investment in a QOF. Thus, after December 31, 2026, the guidance regarding inclusion events is no longer relevant.

The general rule is that a taxpayer recognizes the gain it has deferred through investment in a QOF on the earlier of the date of an inclusion event or December 31, 2026. Generally, an event is an inclusion event only if and to the extent that a taxpayer transfers all or part of its qualifying investment and that transfer reduces the taxpayer's equity interest in the QOF. However, subject to additional rules and exceptions, a taxpayer's receipt of a distribution from a QOF can be an inclusion event regardless of whether the taxpayer's ownership interest in the QOF is reduced.

Inclusion Events:

- Sale or exchange of all or a portion of a qualifying investment to the extent that there is a reduction in the taxpayer's equity interest in the qualifying investment; note that a taxpayer's transfer of its qualifying investment to an entity that is disregarded as separate from the taxpayer for federal income tax purposes is not an inclusion event because the transfer is disregarded for federal income tax purposes;
- Subject to exceptions, the receipt of property (including cash) in a distribution (regardless of whether the taxpayer's equity interest is reduced);
- Termination or liquidation of the QOF;
- Liquidation of QOF owner (QOF shareholder or partner)(with special rules for §336 and 337 distributions);
- Claim of worthlessness;
- Gifting a QOF qualifying investment (although there are special rules for transfers to grantor trusts); and
- Any transaction that has the effect of reducing either (1) the amount of remaining deferred gain of one or more direct or indirect partners, or (2) the amount of gain that would be recognized by those partners on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event to the extent that such amount would reduce that gain to an amount less than the remaining deferred gain (this rule is referred to as the ''remaining deferred gain reduction rule'').

A transfer of a QOF qualifying investment by reason of death is generally **not** an inclusion event. In addition, a contribution of a qualifying investment in a QOF to a grantor trust where the owner of the qualifying investment is the deemed owner of the trust under the grantor trust rules, is not an inclusion event. However, a change in grantor trust status is an inclusion event unless it is a termination of grantor trust status by reason of the death of the owner.

Subject to the remaining deferred gain reduction rule, a §721 contribution of a qualifying investment in a QOF partnership is generally not an inclusion event as long as the transfer does not cause a termination of the QOF partnership or the direct or indirect owner of the QOF. The inclusion rules will apply, however, to any part of the transaction to which §721(a) does not apply. In addition, again subject to the remaining deferred gain reduction rule, a §708(b)(2)(A) merger or consolidation of a partnership that holds a qualifying investment, or of a partnership that holds an interest in such partnership, in a §708(b)(2)(A) transaction, is generally not an inclusion event. However, the general inclusion rules will apply to any part of the transaction that is otherwise treated as a sale or exchange.

Subject to the remaining deferred gain reduction rule, an actual or deemed partnership distribution allocable to a qualifying investment is only an inclusion event to the extent that the distributed property has a fair market value in excess of the partner's basis in the qualifying investment. This should allow distributions of operating cash flow in many circumstances (due to the allocation of income that will increase investors' bases).

Notwithstanding any of the regulatory guidance on inclusion events, the regulations provide the Commissioner with the ability to publish guidance providing that a type of transaction is or is not an inclusion event.

There are additional rules in the regulations regarding inclusion events that are related to S corporations and C corporations that are not analyzed in this article.

If an inclusion event occurs, what is the amount of gain included in gross income?

As an overall limitation, the total amount of gain included in gross income on the date of an inclusion

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event is limited to the remaining amount of deferred gain reduced by any increase in basis made under §1400Z-2(b)(2)(B)(iii)(the 10% step-up in basis after five years) or §1400Z-2(b)(2)(B)(iv)(the 5% step-up in basis after seven years).

Subject to the overall limitation, the determination of the amount of gain included in gross income when an inclusion event occurs is dependent upon the type of inclusion event.

Certain Enumerated Inclusion Events:

If there is an inclusion event due to any of the following:

- a distribution by a QOF partnership in excess of a partner's basis,
- application of the remaining deferred gain reduction rule,
- a distribution by a QOF C corporation,
- a dividend-equivalent redemption,
- a qualifying §381 transaction,
- a §355 transaction,
- a recapitalization, or
- a §1036 transaction,

the amount of deferred gain included in gross income is equal to the lesser of (1) the remaining deferred gain or (2) the amount that gave rise to the inclusion event. The ''amount that gave rise to the inclusion'' is dependent upon the type of inclusion event and, in most cases, is specifically defined in the regulations (e.g., on a partnership distribution that is an inclusion event, this amount would be the amount of the distribution that exceeds the distributee partner's basis).

Example: On January 15, 2019, Taxpayer A realizes $500,000 of capital gain that it can defer through investment in a QOF. On June 1, 2019, A invests the $500,000 into a QOF partnership in exchange for a qualifying investment. On August 1, 2022, the QOF borrows $200,000 on a recourse basis and the liability is allocated entirely to partners other than A. On December 1, 2022, the QOF distributes $100,000 in cash to A. The $100,000 distribution to A is an inclusion event because it exceeds A's basis in its qualifying investment (which is zero). The amount of the deferred gain that A recognizes is $100,000 (the lesser of the $500,000 of remaining deferred gain and the $100,000 amount that gave rise to the inclusion event). Note that under the basis ordering rules, A will increase its basis in its QOF interest by the $100,000 of included gain before A determines the other tax consequences of the event. Thus, A recognizes no gain under §731 in this example. After the distribution, A's basis is zero (increased by $100,000 due to the inclusion of deferred gain in income and decreased by $100,000 due to the distribution).

Other Inclusion Events:

For other inclusion events, subject to the overall limitation, the amount of remaining deferred gain included in gross income is determined as follows (unless the special rule applicable to a QOF partnership or S corporation applies):

(1) Multiply the fair market value (on the date of the inclusion event) of the taxpayer's entire qualifying investment in the QOF by the percentage of the taxpayer's qualifying investment that was disposed of in the inclusion event = the fair market value of the portion of the qualifying investment that was disposed of in the inclusion event (''x'');

(2) Determine the ratio of x/y where ''y'' is the fair market value of the total qualifying investment immediately prior to the inclusion event;

(3) Multiply that ratio (x/y) by the remaining deferred gain, which gives you an amount that bears the same proportion to the remaining deferred gain as the fair market value of the portion of the qualifying investment that was disposed of bears to the fair market value of the total qualifying investment;

(4) Take the lesser of the amount determined under (3) and ''y'' (the fair market value of the total qualifying investment);

(5) Determine the excess, if any, of the amount determined under (4) over the taxpayer's basis in the portion of the qualifying investment disposed of in the inclusion event = amount of deferred gain included in gross income.

In a QOF partnership or S corporation, this computation is done differently. In that context, the deferred gain included in gross income is determined as follows:

(1) Determine the remaining deferred gain (taking into consideration any basis adjustments that have been made under §1400Z-2(b)(2)(B)(iii) (five-year step-up) or (iv) (seven-year step-up));

(2) Multiple the amount determined in (1) by the percentage of the qualifying investment that gave rise to the inclusion event;

(3) Compare the amount determined in (2) to the gain that would be recognized on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event; the lesser

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amount is the deferred gain included in gross income.

Example:

On January 15, 2019, Taxpayer A realizes $500,000 of capital gain that it can defer through investment in a QOF. On June 1, 2019, A invests the $500,000 into a QOF partnership in exchange for a qualifying investment. On August 1, 2020, the QOF borrows $200,000 on a nonrecourse basis. A's allocable share of the debt is $100,000. On July 15, 2024, A sells 50% of its qualifying investment in the QOF for $400,000 cash. At the time of the sale, the fair market value of the QOF's property is $1.8 million. Assume that there are no other inclusion events, distributions, allocations, or changes in the amount or allocation of outstanding debt. At the time of the sale, A has held the qualifying interest for over five years and, therefore, there is a 10% increase in the basis of the interest. A's basis in its entire interest immediately prior to the sale is, therefore, $150,000 (original zero basis plus $100,000 liability share plus $50,000 five-year step-up in basis). The sale of 50% of A's interest requires A to recognize $225,000 of previously deferred gain (the lesser of $225,000 (remaining deferred gain ($450,000) x the percentage of the qualifying investment that A sold (50%)) or $325,000 (the gain A would recognize on a fully taxable disposition of 50% of A's interest ($400,000 minus $75,000 basis)). A also recognizes $100,000 of gain with respect to the appreciation in the interest sold.

The amount of gain recognized on December 31, 2026, is equal to the excess of (1) the lesser of (a) the remaining deferred gain and (b) the fair market value of the qualifying investment held on December 31, 2026 over (2) the taxpayer's basis in the qualifying investment on December 31, 2026.

Does a partner in a QOF partnership receive a basis increase equal to its allocable share of liabilities?

Under Subchapter K, §752(a) treats any increase in a partner's share of partnership liabilities as a contribution of cash by the partner to the partnership. Generally, a partner increases its basis in its partnership interest in an amount equal to its allocable share of partnership liabilities. The 2018 proposed regulations provided that deemed contributions of cash to a QOF taxed as a partnership that occur when the QOF incurs debt do not create a separate interest in the fund (to which the opportunity zone tax benefits would not have attached). However, those regulations did not specifically address whether that meant that a partner in a QOF is allowed to increase its basis in a qualifying investment by the amount of its allocable share of partnership liabilities. The provisions and the examples in the 2019 proposed regulations make it clear that this basis increase is allowed.

If an investor has a mixed-funds investment in a QOF partnership, does the investor have two separate bases?

Yes. A partner that holds both a qualifying investment and a non-qualifying investment in a QOF partnership is treated as holding two separate interests in the partnership and the basis of each interest is computed separately. Thus, all §704(b) allocations of income, gain, loss, and deduction, all §752 allocations of debt, as well as distributions, that a QOF partnership makes with respect to a partner who owns both a qualifying and non-qualifying investment are treated as if they are made to two separate interests based on the allocation percentages of the interests. The allocation percentages are determined based on the relative capital contributions attributable to each investment. If either or both of the partner's interests are increased (e.g, the partner makes an additional contribution to the QOF), the partner's interests are valued immediately prior to the event and the allocation percentages are adjusted accordingly.

What are the rules applicable to debt-financed distributions by a QOF partnership?

This may be the question most often asked by potential investors in QOFs that are investing in real estate development—can the investors receive a tax-free debt-financed distribution without triggering gain and/or jeopardizing the OZ tax benefits? Normally, under Subchapter K, a partner is able to receive a debt-financed distribution tax-free to the extent of that partner's adjusted basis in the partnership. A liability allocation increases basis and a subsequent distribution of proceeds from the borrowing is tax-free to the extent of the partner's adjusted basis.

Under the proposed 2019 regulations, a debt-financed distribution is **generally** allowed. There is an example in the regulations of a QOF that borrows money on a nonrecourse basis three years after investors make their qualifying investments in the QOF; in that example, the debt is allocated to the investors in accordance with the rules under §752(a) and the QOF distributes a portion of the proceeds from the borrowing to one of the investors. In the example, the distribution is not an inclusion event (does not trigger inclusion of previously deferred gain) and there is no gain recognized on the distribution because the investor has sufficient basis to absorb the distribution. The investor's basis in its QOF interest is reduced by the amount of the distribution.

However, there are two very important exceptions to the general rule that a debt-financed distribution from a QOF partnership does not affect the availability of OZ benefits:

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(1) There is a provision that treats any distribution from a QOF partnership to a QOF investor holding a qualifying investment that has remaining deferred gain as an inclusion event if and to the extent that the distribution exceeds the distributee partner's tax basis. Note that if the investor holds a mixed-funds investment, only the portion allocable to the qualifying investment is subject to this rule. The general §731 distribution rules will apply to the remainder of the distribution. Note also that, as discussed in the inclusion event sections above, this rule applies to **any** distribution from the QOF, not just a debt-financed distribution.

(2) There is a provision that requires the QOF partnership to analyze any distribution to determine whether the §707 disguised sale rules would treat the contribution of cash or other property to the QOF in exchange for the qualifying investment and the subsequent distribution as a disguised sale. In making this determination, (a) any cash contributed is treated as non-cash and (b) in the case of a debt-financed distribution, the partner's share of liabilities is zero. If, applying these rules, the distribution would be a disguised sale under §707, then to the extent there would have been a disguised sale, the original transfer of the deferred gain to the QOF partnership is not treated as an investment for which a deferral election could be made. Again, this rule applies to any distribution from the QOF, not just a debt-financed distribution.

Comment: A QOF partnership must carefully examine any distributions it makes to an investor **within the first two years** of an investor's otherwise qualifying investment in the QOF. A distribution after this two-year time period that is in excess of an investor's basis will also be problematic under (1) above in that it is considered an inclusion event (triggering recognition of a portion of the original deferred gain) to the extent it exceeds the distributee's basis and is made while the distributee still has remaining deferred gain. However, distributions within two years, if treated as §707 disguised sales under the rule described in (2) above, will actually change the character of the investor's original investment from a qualifying investment to a non-qualifying investment. It is important to note that when analyzing whether the §707 rules apply, a cash contribution is treated as a non-cash contribution—so even if an investor has not contributed property other than cash to the QOF and even if the investor is receiving cash in the distribution, the disguised sale rules can apply to re-characterize the investment for OZ purposes.

How do you determine the holding period of a QOF investment?

The holding period for a QOF investment is extremely important because the OZ tax benefits are dependent upon an investor holding a qualifying investment for five, seven, and 10 years. If a taxpayer receives a qualifying investment in a QOF in exchange for property, the taxpayer's holding period for the qualifying investment is determined without regard to the taxpayer's holding period in the property that was transferred to the QOF.

If a taxpayer receives a qualifying investment in a QOF as a gift that was not an inclusion event (i.e., a contribution to a grantor trust) or by reason of the prior owner's death, the taxpayer's holding period for the qualifying investment includes the time that the donor or deceased owner held the interest. In other words, the holding period tacks.

There are additional holding period rules in the regulations relevant to C corporations that are not discussed in this article.

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How do the basis adjustment rules apply in the context of a tiered arrangement?

The 2019 proposed regulations provide that in the context of a tiered arrangement (e.g., a situation in which a QOF investor is itself a partnership), the five, seven, and 10 year basis step-ups are allocated to the owners of the QOF and to the owners of any partnerships that directly or indirectly (solely through one or more partnerships) own the QOF interest. The adjustments will track to the owners' interests based on their shares of the remaining deferred gain to which the adjustments relate.

If, after an investor holds an interest in a QOF partnership or S corporation for at least 10 years, the QOF sells qualified opportunity zone property, is the taxpayer able to elect to exclude from income its share of the gain from the sale?

Yes. The 2019 proposed regulations provide that if a taxpayer has held a qualifying investment in a QOF partnership or S corporation for at least 10 years and the QOF disposes of qualified opportunity zone property after that 10-year holding period, the taxpayer can elect to exclude from gross income its share of the capital gain arising from the disposition that is reported on the K-1 and is attributable to the qualifying investment. The taxpayer makes the election for the taxable year in which the capital gain recognized by the QOF partnership or S corporation would otherwise be included in the taxpayer's gross income in whatever manner is prescribed in forms and instructions.

Comment: This is a very impactful and much-needed provision that goes a long way toward solving the issue that existed with respect to exit strategy out of a QOF partnership or S corporation. The statute provides for a basis step-up to fair market value on the ''sale or exchange'' of a fund interest after the investor has held the interest for at least 10 years. The issue is that if a fund that is a pass-through sells assets and distributes the proceeds, that is not a ''sale or exchange'' of the fund interest for tax purposes. Forcing the sale of the fund interest versus a sale of the assets is not economically feasible in many situations.

Comment: It is important to note a couple of things about this provision. First of all, it only applies to a fund's sale of ''qualified opportunity zone property.'' Up to 10% of a fund's assets can consist of non-QOZP. If a fund sells an asset that is not QOZP, the exclusion election is not available. Second, the exclusion is available only with respect to capital gain that arises from the sale of an asset – not ordinary income. Third, this provision is in a section of the regulations that is not effective until final regulations are issued; thus, taxpayers cannot rely on this provision prior to that time.

Comment: It is unclear how an investor would apply this exclusion election if the investor has obtained its qualifying investment over time. The 2018 proposed regulations provided that in certain circumstances, an investor that holds QOF partnership interests with identical rights acquired over time will be able to use the FIFO method when and if the investor sells all or a part of its QOF interest. The 2018 proposed regulations allow the use of the FIFO method to determine three specific issues: (1) whether the investment was one to which the deferral election applied; (2) the attributes of the gain subject to a deferral election at the time the gain is included in income; and (3) the extent, if any, of an increase in basis under §1400Z-2(b)(2)(B) (which are the increases at five years and at seven years, but not the basis step-up election at 10 years). Based on the way in which the 2018 proposed regulations were written, it does not appear that a taxpayer is able to use the FIFO method when it comes to determining the 10-year holding period necessary for the basis step-up to fair market value in §1400Z-2(c), which means that if an investor has made fungible investments (separate investments with indistinguishable property rights) in a QOF partnership over time and sells less than all of its interest prior to the end of the 10-year period beginning on the date of the last investment, the investor will not fully qualify for the gain exclusion.

With respect to the new gain exclusion election in the 2019 proposed regulations discussed in this section, the language in the regulations refers to ''a taxpayer [that] has held a qualifying investment . . . in a QOF partnership or QOF S corporation for at least 10 years.'' Even if the FIFO method provided in the 2018 proposed regulations applied, it does not really solve the issue because the interest itself is not being sold—the QOF is selling an asset and passing through the gain to the investor who is making the exclusion election. Perhaps the way to approach this is to compute the percentage of the investor's qualifying investment that has been held for at least 10 years and apply that percentage to the relevant K-1 capital gain to determine the portion that is eligible for exclusion. There is nothing in the regulations, however, that requires an investor to do this. There is arguably some ambiguity in the reference to a taxpayer that has ''held **a** qualifying investment'' for at least 10 years. Does ''a'' refer to the investment in its entirety or to any portion of the investment? A literal interpretation would lead to the conclusion that as long as an investor has held any part of its qualifying investment for at least 10 years, it has held ''a'' qualifying investment for that period. Thus, if this provision is issued in final form as currently written, regardless of whether the investor has held the entire qualifying investment for 10 years, the investor may be able to elect to exclude any and all capital gain reported on a K-1 that is attributable to the QOF's sale of QOZP.

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In the context of a QOF partnership, is the basis step-up election available after a 10-year hold a step-up to gross fair market value (including liability relief)?

Yes. The 2019 proposed regulations specifically provide that with respect to the election to step-up basis to fair market value upon a sale or exchange of a QOF partnership interest that has been held for at least 10 years, the basis increase includes debt.

Is there depreciation recapture on a sale or exchange of an interest in a QOF partnership to which the taxpayer has applied the fair market value step-up election? In other words, does §751(a) apply?

No. The 2019 proposed regulations provide that immediately prior to the sale or exchange of a QOF partnership interest for which a §1400Z-2(c) election is being made (step-up in basis to fair market value), the bases of the QOF assets are also adjusted, in a manner similar to a §743(b) adjustment. This basis adjustment to the QOF assets will eliminate the ordinary income issue with respect to §751 hot assets, including depreciation recapture.

Comment: Although this provision solves the §751 ordinary income/capital loss issue when an investor sells or exchanges a QOF interest, it does not appear to solve the issue when the QOF sells QOZP (including an interest in a QOZB). As discussed above, if a QOF partnership sells an asset after an investor has held the QOF interest for at least 10 years, that investor can elect to exclude its share of the capital gain from the sale. However, that exclusion provision specifically applies only to capital gain and there is no provision that would eliminate ordinary income on a sale by the QOF of an interest in a QOZB (which could have depreciation recapture or unrealized receivables, etc.).

The QOF

What additional information will a QOF be required to report?

The Preamble to the 2019 proposed regulations provides that the Form 8996 will be amended for the 2019 tax year and following years. There will be additional information required on that form, likely including the EINs of qualified opportunity zone businesses that the QOF invests in and the amount of each such investment. There may be additional information requested on that form as well.

Moreover, there has been a widespread call for increased reporting requirements so that data can be collected and disseminated regarding the impact of opportunity zone investments. Treasury and the IRS have requested comments on methodologies that could be utilized to collect and assess relevant data on opportunity zone investment and its impacts and outcomes relative to economic indicators (e.g., how many jobs were created, what are the increases, if any, in poverty levels, etc.).

How does a QOF value its assets for purposes of the 90/10 test?

The 2018 proposed regulations (and the instructions to Form 8996) provided that if a QOF filed a financial statement with the SEC or another federal agency other than the IRS or if the QOF has an audited financial statement prepared in accordance with U.S. GAAP, the QOF would use the asset values as reported on its financial statement as the relevant value for the 90% test. If the QOF did not have a financial statement that meets these requirements, value would be based on the QOF's cost.

The 2019 proposed regulations change this and instead provide that a QOF generally has a choice of valuation method. For each tax year, it can value its assets using the applicable financial statement valuation method (if it has an applicable financial statement within the meaning of Reg. §1.475(a)-4(h)) or the alternative valuation method. A QOF can change methods year to year but must apply a single method consistently during each taxable year to all of its assets.

Comment: This is a welcome change from the valuation guidance in the 2018 regulations. The 2019 proposed regulations allow a QOF flexibility to choose its valuation method on a year-to-year basis.

> **Applicable Financial Statement Valuation Method:**
>
> Under the applicable financial statement valuation method, the QOF will value its assets based on the value of each asset that it owns or leases as reported on the applicable financial statement for the relevant reporting period (if it has an applicable financial statement within the meaning of Reg. §1.475(a)-4(h)). However, if the QOF is leasing assets, this method is only available if the applicable financial statement is prepared according to U.S. GAAP and assigns a value to the lease of the asset.
>
> **Alternative Valuation Method:**
>
> Under the alternative valuation method, the value of each asset owned by the QOF is the QOF's unadjusted cost basis of the asset under §1012. The value of each asset leased by the QOF is the sum of the present values of each payment under the lease for the asset, as determined at the time the QOF enters into the lease. For purposes of making this calculation, the term of a lease includes periods during which the lessee is able to extend the lease at a pre-defined rent. Once the QOF calculates the value of a leased asset, that value remains the same for all testing dates. The applicable dis-

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count rate is the applicable Federal rate under §1274(d)(1).

Assets Excepted From Application of the 90/10 Test:

A QOF also has the option (under either the applicable financial statement method or the alternative valuation method) to do the 90/10 calculation excluding certain property from both the numerator and denominator if the following three requirements are met:

- The property was received by a QOF partnership as a contribution or by a QOF corporation solely in exchange for stock of the corporation;
- The contribution or exchange occurred not more than six months before the relevant testing date; and
- Between the time the QOF received the property and the testing date, the amount was held in cash, cash equivalents or debt instruments with a term of 18 months or less.

A QOF is able to make a decision with respect to excluding property that meets these requirements for each testing date—it does not need to be consistent from one date to the next.

Comment: This new rule gives QOFs flexibility with respect to cash acquired within a short time (six months) of its next testing date to allow the QOF a period of time to decide how to deploy that money.

Comment: Note that this is the only ''grace period'' afforded a QOF with respect to the 90/10 test. Many commentators suggested a start-up grace period of at least 18 months from the time a QOF is formed before its first testing period would begin. Other than this limited exception for cash received during the six months prior to a testing date, there is no other grace period in either set of proposed regulations. In fact, the 2019 proposed regulations specifically provide that except as provided in Reg. §1.1400Z(2)(d)-1(a)(2)(ii) (which allows a QOF to ignore (for purposes of the 90/10 test) any months before the first month in which it certifies as a QOF), if a QOF fails to satisfy the 90/10 test, the QOF must pay the penalty for each month that it fails the test. If a QOF invests its cash in operating subsidiaries by its testing dates, this issue is alleviated as long as the subsidiary meets the working capital safe harbor.

How long does a QOF have to re-invest capital upon the sale of qualified opportunity zone property (QOZP)?

Section 1400Z-2(e)(4)(B) specifically authorizes regulations to make sure that a QOF has a ''reasonable period'' in which to re-invest the return of capital from investments in qualified subsidiaries and/or the proceeds from a sale or other disposition of QOZP. The 2019 proposed regulations provide that a QOF has 12 months within which to reinvest proceeds from a return of capital or the sale or other disposition of qualified opportunity zone property. If and to the extent that the QOF reinvests the proceeds in QOZP within 12 months, the proceeds are treated as QOZP for purposes of the 90/10 test.

What are the tax consequences with respect to interim sales of QOF assets? Does the reinvestment of proceeds by the QOF within 12 months mean that the investors (if the QOF is a pass-through) or the QOF (if QOF is a corporation) do not recognize any gain on the sale?

This is a significant issue because there will be many circumstances in which it is in a QOF's economic interest to sell assets. The statute clearly contemplated re-investment of capital proceeds from such sales but is silent as to whether the re-investment is treated as continuous investment such that no gain is recognized. It was clear from the comments in the Preamble to the 2018 proposed regulations that Treasury and the IRS understood the need for clarification but they needed to provide this clarity in the context of a ''statutorily permissible possibility.''

Unfortunately, they have come to the conclusion that they do not have the authority to provide for the nonrecognition of gain on a sale of an asset by a fund. In the context of a QOF partnership, if the sale occurs after an investor has held its fund interest for at least 10 years, the investor is able to elect to exclude the gain allocated to that investor. However, in all other cases, a sale is a taxable event and there is no applicable nonrecognition provision.

Comment: This could be a significant issue for certain types of funds, including venture capital investment in start-ups. The economics of venture investing generally requires sales of businesses prior to the 10-year mark. Congress needs to consider a legislative fix for this issue in order to avoid creating a disincentive for certain types of investments.

Qualified Opportunity Zone Business Property (QOZBP)

What is a "trade or business" for purposes of determining whether a QOF uses property in a trade or business?

An activity is a trade or business if it would be considered a trade or business under §162.

When does "original use" commence with respect to tangible property acquired by purchase?

The regulations tie the date that original use commences with the placed in service date for purposes of

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depreciation or amortization. They provide that the original use of tangible property acquired by purchase commences on the date any person first places the property in service in the QOZ for purposes of depreciation or amortization (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). So, if property has been depreciated or amortized by any other person (or could have been if the user had been the owner of the property), that property is not original use property and must be substantially improved to be qualified opportunity zone business property.

Can used tangible property acquired by purchase ever qualify as "original use" property?

Yes, but only if the property has not previously been used within that QOZ in a manner that would have allowed it to be depreciated or amortized by any taxpayer.

Comment: This rule appears to allow a taxpayer to purchase used tangible property located outside of a QOZ and move it into a QOZ as long as that taxpayer is the first to have used that property in that QOZ in a manner that would allow depreciation or amortization.

If property is vacant for a period of time can it qualify as "original use property"?

Yes. Under the 2019 proposed regulations, if property in a zone has been unused or vacant for an uninterrupted period of at least five years, original use in the zone commences on the date after the period of non-use or vacancy when any person first uses the property in the zone. Several commenters had requested that the necessary vacancy period be one year but Treasury and the IRS were concerned that owners could abuse the provision by intentionally abandoning property in an effort to increase its value as original use property in a QOZ.

Does the substantial improvement test apply to unimproved land?

No. Unimproved land that is in a QOZ and is acquired by purchase pursuant to the rules does not have to be substantially improved. However, land must be used in a trade or business in order to be considered QOZBP. In addition, the 2019 proposed regulations provide that a QOF is not allowed to rely on the ''no substantial improvement'' regulation if the land is unimproved or minimally improved and the QOF or qualified opportunity zone business (QOZB) purchased the land with an expectation, an intention, or a view not to improve the land more than an insubstantial amount within 30 months of the date of purchase. This provision is an exception to the general rule allowing a taxpayer to rely on these proposed regulations.

Comment: The Preamble acknowledges that there is potential for abuse here but in addition to the language that requires more than minimal improvement in order to rely on the proposed regulatory rules, there is also a general anti-abuse rule in the regulations that could be used in circumstances in which there is not sufficient new investment being made (which would essentially amount to ''land-banking''). The Preamble to the 2019 proposed includes an example of a taxpayer purchasing land that was used to grow a crop (whether active or fallow) and states that the purpose of the OZ rules would not be realized if the taxpayer does not increase any economic activity or output of the parcel. This does not mean that farming is not a qualifying QOZB business; it simply means that if a QOF or QOZB purchases unimproved land and does little to nothing with it in terms of increasing its economic uses then there has not been sufficient new investment in the property to comply with the intent of the OZ program. If a significant purpose for acquiring the unimproved land was to achieve this inappropriate tax result then the general anti-abuse rule would apply.

Does a taxpayer have to satisfy the substantial improvement test on an asset-by-asset basis or can it be satisfied on an aggregate basis?

As of now, the test is applied on an asset-by-asset basis, although Treasury and the IRS have acknowledged that an aggregate approach (allowing tangible property to be grouped by location or type in the same, or contiguous, qualified opportunity zones) would incentivize investment.

Comment: There are several circumstances in which an aggregate approach would be far preferable and may even be necessary for a transaction to be economically viable. One example is the purchase or expansion of an existing business in a QOZ. If, in applying the 70/30 test to the tangible property, each asset has to either be original use property or be substantially improved, qualifying as a QOZB could be very difficult. Aggregation rules could make this type of transaction far more attractive to investors.

Are there any special rules applicable to inventory?

The 2019 proposed regulations provide a safe harbor for inventory in transit. Pursuant to this safe harbor, inventory that is in transit either (1) from a vendor to a facility of the trade or business that is in a QOZ or (2) from a facility of the trade or business that is in a QOZ to customers of the trade or business that are located outside a QOZ is considered as being used in a QOZ.

Can property leased directly by a QOF be QOZBP?

Yes. The 2019 proposed regulations clearly state that a QOF is able to lease property and have it qualify as QOZBP if the requirements are met.

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What requirements must be met in order for leased property to be considered QOZBP (by either a QOF or a QOZB)?

With respect to all leased property, the property will be QOZBP if (1) it is acquired under a lease entered into after December 31, 2017, (2) the terms of the lease are market-rate (as determined under §482) at the time it is entered into, and (3) during substantially all of the QOF's holding period for the property, substantially all of the use of the property was in a QOZ.

Those two requirements are applicable to all leases. In addition, there is a general anti-abuse provision applicable to leases. That rule provides that if there is a lease of real property (other than unimproved land) and, at the time the lease is entered into, there is a plan, intent, or expectation that the QOF will purchase the real property for an amount other than the fair market value of the property as determined at the time of purchase without regard to prior lease payments, the leased real property is not QOZBP at any time.

There is no general ''original use'' or ''substantial improvement'' test applicable to leased property.

In addition, there is no prohibition on related party leases. However, there are additional rules applicable to a related party lease. First, the lessee cannot, at any time, make a prepayment of rent relating to a period of use that exceeds 12 months. Second, if the original use of leased tangible **personal** property does not commence with the lessee, the lessee must become the owner of an equal amount (in value, as determined under the valuation method chosen by the QOF) of tangible property that is QOZBP within the relevant testing period and there must be substantial overlap in the zones in which the lessee uses the leased tangible personal property and the acquired tangible property. The ''relevant testing period'' begins on the date that the lessee receives possession of the leased tangible personal property and ends on a date that is the earlier of (1) the date 30 months after the date the lessee received possession of the leased tangible personal property or (2) the last day of the term of the lease (which will include periods during which the lessee may extend the lease at a pre-defined rent).

Do lessee improvements to leased property qualify as "original use" property?

Yes. Improvements that a lessee makes to leased property satisfy the original use requirement as purchased property equal to the unadjusted cost basis of the improvements.

Qualified Opportunity Zone Businesses (QOZBs)

A QOZB is a trade or business that meets all of the following requirements:

(1) Substantially all (70% under the 2018 proposed regulations) of the tangible property owned or leased by the QOZB is QOZBP;

(2) At least 50% of the QOZB's total gross income is derived from the active conduct of a trade or business in the zone;

(3) A substantial portion of the QOZB's intangible property is used in the active conduct of the business;

(4) Less than 5% of the average of the aggregate unadjusted bases of property is attributable to nonqualified financial property (''NQFP,'' which does not include reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less); and

(5) The business does not include operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, gambling establishment, or a store if the principal business is the sale of alcohol for consumption off premises.

For purposes of applying the 70/30 test applicable to a QOZB's owned or leased tangible property, how is the property valued?

Substantially all (70%) of the property owned or leased by a QOZB must be QOZBP. In determining whether this test is met, a QOZB will value its tangible property by following the same rules that apply to a QOF in valuing its assets under the 90/10 test. The QOZB generally has a choice from year-to-year to either use the financial statement valuation method (if it has an applicable financial statement within the meaning of §1.475(a)-1(h)) or the alternative valuation method. These methods are discussed more fully, above.

For purposes of applying the 50% of gross income test listed above, how is a QOZB's income sourced? In other words, when is it considered "derived" from the active conduct of a trade or business "in the zone?"

One of the most critical outstanding issues with respect to the OZ program was how and to what extent the program could work in the context of investment in operating businesses. The lack of regulatory guidance on income sourcing was one of the main sources of uncertainty. The 2019 proposed regulations provide broad, flexible income sourcing rules that will allow many different types of businesses in various industries to qualify; there are three separate safe harbors that a business can rely on and if none of those apply, a general facts and circumstances test can be applied.

The first two safe harbors focus on the services performed for a trade or business by employees, independent contractors (and employees of independent con-

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tractors). Under the first safe harbor, if at least 50% of all of those services, based on **hours** , are performed in a QOZ, the test is met. The determination is made based on a ratio where the numerator is the total hours of services performed in a QOZ during the taxable year and the denominator is the total hours of services performed in a taxable year. Under the second safe harbor, if at least 50% of all of those services, based on the total amount paid by the entity for the services, are performed in a QOZ, the test is met. The determination is made based on a ratio where the numerator is the total amount paid by the entity for services performed in a QOZ during the taxable year and the denominator is the total amount paid by the entity for services performed during the taxable year.

Example: The Preamble to the 2019 proposed regulations provides the following examples of the first two safe harbors: A tech start-up that develops software for global sale through internet downloads has its campus in a QOZ. The majority of the total hours spent on the business are spent by employees and independent contractors doing the development work from within a QOZ. The business meets the first safe harbor. If the business also uses a service center, located outside of a QOZ, the business is still able to qualify even if the majority of the services performed for the business, from an hours perspective, occur at the service center. As long as the total amount that the business pays for services performed within the QOZ (the software development services) is at least 50% of the total amount it pays for services overall, the business meets the second safe harbor.

Comment: The second safe harbor allows a trade or business to locate one or more facilities outside of a QOZ and meet the 50% of gross income test as long as its highest paid employees are working from within a QOZ. As long as the business is paying at least 50% of the total amount it pays for services to the employees/independent contractors located in the QOZ, the 50% of gross income test can be satisfied.

Comment: The first safe harbor should allow a business to have different locations from which it operates its business (e.g., a business that owns three restaurant locations) as long as the activity is considered one trade or business and the majority of hours spent by all employees and independent contractors occur in a QOZ. Depending on the business and the size of the activities outside a QOZ, this may mean that the majority of locations need to be within QOZs.

Under the third safe harbor, if tangible property located in a QOZ as well as management or operational functions performed in a QOZ are each necessary for the generation of at least 50% of the gross income of the trade or business, the test is met.

Example: The regulations provide the following example of the third safe harbor: A landscaping business has both its headquarters and its management function in a QOZ. The employees and managers that are located in the QOZ manage the activities of the business, whether they take place within or outside of a QOZ. The equipment and supplies are stored in the headquarters facility. This business would meet the third safe harbor because there is tangible property located in a QOZ (equipment and supplies) and management occurring from within a QOZ, both of which are necessary (the example in the regulations uses the phrase ''material factors'') in the generation of the income of the business.

Comment: Note here that this example does not even mention where customers are located and whether or not at least 50% of them reside in QOZs. Those facts are not relevant under this safe harbor. In fact, customer location is not generally relevant at all under the three safe harbors, with the exception of the first safe harbor in the context of a services business where employees and/or independent contractors are performing services for customers within and outside of QOZs and the hours spent performing those services will be compared.

The regulations provide an example of a business with a PO Box located in a QOZ that states that the receipt of mail at that PO Box is ''fundamental'' to the business but indicates that there is no other basis for concluding that the income of the trade or business is derived in the QOZ. Thus, it is insufficient in and of itself to qualify the business under the OZ rules. The mere location of the PO Box is not a material factor in the generation of gross income.

If none of these safe harbors is met, the business can apply a facts and circumstances test to determine whether the 50% of gross income test is met.

To the extent that the tests applicable to a QOZB require an analysis of whether a QOZ is the location of services, tangible property, or business functions, how are businesses that straddle QOZs treated?

If a business uses real property located in a QOZ and also uses real property that is located outside of a QOZ (the business holds property straddling multiple Census tracts, not all of which are designated as QOZs), the rule in §1397C(f) applies such that all of the real property is deemed to be located within a QOZ for purposes of applying the QOZB tests if:

- The amount of real property (based on square footage) that is located in a QOZ is substantial as compared to the amount outside of the QOZ; and
- The real property located outside the QOZ is contiguous to part or all of the real property located inside the QOZ.

The Preamble provides that real property located within the QOZ should be considered substantial if

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the unadjusted cost of the real property inside a QOZ is greater than the unadjusted cost of real property located outside of the QOZ.

For purposes of the requirement that a QOZB use a substantial portion of its intangible property in the active conduct of the business, what does "substantial portion" mean?

The 2019 proposed regulations provide that for purposes of this test, a ''substantial portion'' is 40%.

Does the leasing of residential rental property qualify as an active trade or business for purposes of the definition of a QOZB?

Yes. The 2019 proposed regulations clarify that the ownership and operation of real property, including leasing, is considered the active conduct of a trade or business for purposes of applying §1400Z-2(d)(3)(A)(definition of a QOZB).

However, merely entering into a triple-net-lease with respect to real property is not considered the active conduct of a trade or business. A taxpayer will need to conduct some other activity with respect to the leased property in order for there to be an active trade or business under the OZ rules.

How is the reasonable working capital exception from the definition of non-qualified financial property (NQFP) applied in the context of an operating business?

The 31-month working capital safe harbor provided in the 2018 proposed regulations was limited in its application and was relevant only to property development—specifically the acquisition, construction, and/or rehabilitation of tangible business property in a QOZ. The regulations did not provide a safe harbor or any other guidance on how the concept of reasonable working capital would be applied in the context of other types of business activities. The 2019 proposed regulations amended the guidance on the working capital safe harbor and provide that the safe harbor applies if amounts are designated in writing for the development of a trade or business in a QOZ, including when appropriate, the acquisition, construction, and/or substantial improvement of tangible property in the zone.

Example: The regulations provide an example of the use of the working capital safe harbor in the context of an operating business. In the example, the business entity (QOZB that has received cash from a QOF) is opening a fast-food restaurant in a QOZ and has a 20-month schedule to deploy cash. The written schedule outlines the planned uses for the cash. The business holds the cash it has not yet deployed in assets described in §1397C(e)(1)(cash, cash equivalents, and debt instruments with a term of 18 months or less) and uses the cash in a manner consistent with the plan and schedule. The business is complying with the working capital safe harbor.

Comment: If capital is being deployed to develop an operating business in a QOZ, there must be a written plan; clients should document the anticipated uses of working capital and should have commercially reasonable business plans that support the use of specified amounts of working capital.

The two examples in the 2019 proposed regulations on the working capital safe harbor provide a number of examples of the types of expenditures that an operating business could list in its written plan, including:

- Identifying favorable locations for the business in the QOZ;
- Leasing suitable space;
- Outfitting the space with equipment and furniture;
- Making necessary security deposits;
- Obtaining a franchise;
- Obtaining local permits;
- Hiring, training and paying salaries to employees and independent contractors;
- Performing R&D; and
- Paying development costs.

This list is not exhaustive but is illustrative of the types of expenses an operating business may incur and how specific the written plan should be with respect to the use of working capital pursuant to the written plan.

Are there circumstances in which the 31-month working capital safe harbor will be extended and, if so, what are those circumstances?

The 2019 proposed regulations provide that if there is a delay caused by waiting for governmental action and the application for that action is complete, the delay does not cause a failure to comply with the working capital safe harbor.

Comment: As of now, this is the only regulatory extension provision. There are certainly other circumstances in which 31 months may not be sufficient. There are often unforeseen events outside of a QOZB's control that delay completion. Perhaps in these instances the reasonable cause exception from the penalty for a QOF's failure to comply with the 90/10 test would apply.

For purposes of the working capital safe harbor, does each contribution of cash to a QOF begin its own 31-month period? Is a business able to apply the working capital safe harbor more than once and/or overlap 31-month periods?

It is quite common in both real estate and business development to capitalize a project in stages with contributions made over time. If a QOF contributes cash

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to a QOZB over time, does the QOZB have 31 months from **each** contribution date to use the contributed cash pursuant to a written plan? Yes. The 2019 proposed regulations provide that a single business is able to benefit from multiple overlapping or sequential applications of the safe harbor as long as each time it is applying the safe harbor, the application independently meets all of the applicable requirements.

Example: On Date 1, a business entity (QOZB) receives cash from a QOF to start a new business and the QOZB writes a plan for use of the Date 1 cash in the development of the business over a period of time not exceeding 31 months from the date of the contribution. Two years later, on Date 2, the QOZB receives additional cash from the QOF to use in the business and writes a plan for use of the Date 2 cash in the further development of the business over a period of time not exceeding 31 months from the date of the contribution. The QOZB holds the cash from both contributions that it has not yet deployed in assets described in §1397C(e)(1)(cash, cash equivalents and debt instruments with a term of 18 months or less) and uses the cash in a manner consistent with the two plans and schedules. The business is complying with the working capital safe harbor.

What is the meaning of the phrase "substantially all" as used in various places in the statute?

The 2018 proposed regulations answered this question with respect to use of the phrase "substantially all" in the context of the QOZB tangible property test (70%). The 2019 proposed regulations provide that "substantially all" generally means 70% but means 90% when applied to holding periods.

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Code Section:	Context:	Meaning of Substantially All
1400Z-2(d)(2)(B)(i)(III)	Definition of Qualified Opportunity Zone Stock: Rule that requires that during **substantially all** of the QOF's holding period for the stock, the corporation qualified as a QOZB	90%
1400Z-2(d)(2)(C)(iii)	Definition of Qualified Opportunity Zone Partnership Interest: Rule that requires that during **substantially all** of the QOF's holding period for the partnership interest, the partnership qualified as a QOZB	90%
1400Z-2(d)(2)(D)(i)(III)	Definition of QOZBP: Rule that requires that in order for property (whether owned or leased) to be considered QOZBP, during **substantially all** of the QOF's holding period for the property, **substantially all** of the use of the property was in a QOZ	70% first time it is used; 90% second time (so during at least 90% of the QOF's (or QOZB's) holding period, at least 70% of the use was in a QOZ)
1400Z-2(d)(3)(A)(i)	Definition of a QOZB: Rule that requires **substantially all** of the tangible property owned or leased by the business to be QOZBP	70%

CONCLUSION

In my article on the 2018 proposed regulations I stated that the approach in that set of regulations evidenced a desire on the part of Treasury and the IRS to facilitate opportunity zone transactions. In spite of the fact that some issues remain, the second set of regulations continues to evidence this same intent. This second set of proposed regulations provide guidance on key aspects of the OZ program and give taxpayers additional options for investment that will satisfy the requirements.

It remains to be seen how Treasury will respond to comments on the 2018 proposed regulations and whether and to what extent the tax community's comments on this newest set of proposed regulations will result in change to this guidance. **There is, however, a way forward.** Taxpayers and their tax advisors are able to rely on both sets of proposed regulations and, in most instances, **there is now enough there to structure both real estate development projects and investment in operating businesses with confidence that the transactions meet the OZ requirements**.

I end this article the same way I ended the October, 2018 article because this statement remains true (especially in light of the new general anti-abuse rule):

> If a taxpayer takes a reasoned approach in a legitimate market-driven transaction that is not abusive and structures and operates a QOF investment in a manner that furthers the policy behind the program (facilitating economic growth and development in an opportunity zone), there should be little risk that the transaction will fail to qualify for the tax incentives based solely on a difference in the interpretation of a term or definitional test in the statute.

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