A PRIMER ON QUALIFIED OPPORTUNITY ZONES INCLUDING CHANGES MADE BY THE FINAL REGULATIONS

1. Background

The Tax Act[1] passed by Congress in 2017 ("Act") created a new tool for economic development in certain qualified opportunity zones ("OZs" or "QOZs"). The legislation created a tax incentive that could help to improve selected urban and rural low-income communities. U.S. investors currently hold $6.1 trillion in unrealized capital gains, which is a tremendous pool for potential investment. However, only a portion of those capital gains, generally gain within the previous 180 days, is eligible for the benefits under Opportunity Zone Program (the "OZ Program" or "QOZ Program").

The OZ Program is founded on several principles. First, the OZ Program is designed to encourage equity rather than loans in OZ. Second, the OZ Program is intended to create long-term rather than short-term investments. Finally, the OZ Program is designed to encourage lasting improvements in the OZs.

Several developments since the passage of the Act have increased the potential impact of the OZ Program. First, the IRS issued proposed Regulations[2] on October 29, 2018 for the OZ Program (the "Original Regulations"). While the Original Regulations did not answer all of the outstanding issues, they did resolve a number of issues making some transactions feasible. Additional Regulations[3] were issued on April 17, 2019 (the "Additional Regulations"). The Additional Regulations clarified how investors could structure investments of capital gains, particularly with regard to operating businesses in OZs. Then, on December 19, 2019, the IRS issued final regulations (the "Regulations") with an effective date of March 13, 2020. The Regulations consolidated the Original Regulations and the Additional Regulations and added some additional provisions.

Another significant development was that President Trump issued an Executive Order on December 12, 2018, establishing the White House Opportunity and Revitalization Council which includes 17 high level members of the administration, chaired by the Secretary of HUD.[4] The Council is charged with establishing policies to prioritize resources and reduce barriers to development in OZs. In April 2019, the Council published an Implementation Plan that targeted forty-nine grants and specialized programs offered by 14 different federal agencies for projects

[1] Pub. L. 115-97 (Sometimes incorrectly referred to as the Tax Cuts and Jobs Act, but due to the Byrd Rule the name was changed to "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018").
[2] https://www.gpo.gov/fdsys/pkg/FR-2018-10-29/pdf/2018-23382.pdf.
[3] https://www.irs.gov/pub/irs-drop/reg-120186-18.pdf.
[4] https://www.whitehouse.gov/presidential-actions/executive-order-establishing-white-house-opportunity-revitalization-council/

and applicants in OZs.[5] In February 2019, Ben Carson, the Secretary of HUD, indicated that HUD will make it easier for developers to use FHA-insured loans on low-income housing tax credit projects in OZs and emphasized the use of the OZ Program for housing. Since then, various federal agencies have adopted guidance regarding efficient use of federal programs in OZ.

2. Overview of Benefits

The goals of the OZ Program are laudable, but successfully leveraging the benefits of the OZ Program has proved difficult because of its complicated and at times conflicting and opaque requirements. This paper sets out the basics of the OZ Program but does not attempt to answer some of the tax nuances that continue to challenge seasoned tax practitioners.

What are the tax benefits of investing in a QOZ? First, if a taxpayer invests capital gains in a Qualified Opportunity Fund ("QOF"), gain is deferred until December 31, 2026 (or the earlier disposition of the QOF interest), provided that the QOF timely invests in eligible QOZ property.[6] The Act provides benefits similar to tax-free, like-kind exchanges under Section 1031 of the Internal Revenue Code, with some notable differences discussed below. The deferred gain maintains its characteristics (i.e. long-term capital gain is taxed as long-term capital gain and short-term capital gain is taxed as short-term capital gain). However, deferral presents the risk that the tax rates may increase over the deferral period. The capital gain rate is low now, and there may be a higher tax rate when the gain is taxed in 2026 or upon earlier disposition of the taxpayer's interest in the QOF.

The second benefit is partial forgiveness of the gain. If an investor holds an interest in the QOF for five years before January 1, 2027, there is 10% forgiveness.[7] So, a taxpayer has a zero percent basis in the QOF investment that goes up to a 10% basis after five years. After seven years, there is an additional 5% forgiveness.[8] Consequently, for an investment held for at least seven years before January 1, 2027, the investor only pays tax on 85% of the original capital gain. For investments after January 1, 2020 and before January 1, 2022, there is only 10% forgiveness. There is no forgiveness for investments after December 31, 2022.

The third benefit of OZ investments is forgiveness of appreciation on investments held for at least ten years. The investment can be held for more than ten years (although tax on 85% of the original gain must be paid on December 31, 2026).[9] Although the QOZs technically expire on December 31, 2028, the investment can be held until December 31, 2047 and appreciation will be forgiven. If the taxpayer holds its interest in the QOF for ten years or more, the appreciation on the investment is exempt from federal income taxes when the taxpayer disposes of its interest in the QOF.

[5] https://www.hud.gov/sites/dfiles/Main/documents/WHORC-Implementation-Plan.pdf
[6] Code § 1400Z-2(a)(1).
[7] Code § 1400Z-2(b)(2)(B)(iii).
[8] IRC § 1400Z-2(b)(2)(B)(iv).
[9] IRC § 1400Z-2(c).

3. Example

The following example summarizes the benefits:

1. December 3, 2018 – Taxpayer sells property that results in $1 million capital gain

2. May 29, 2019 (within 180 days) – Taxpayer invests $1 million in QOF
   - ~ Taxpayer has $0 basis in the investment in the QOF
   - ~ QOF invests the taxpayer's funds in QOZ Property or a QOZ Business (see timing discussion below)

3. May 29, 2024 (5 years) – Taxpayer's basis in investment is $100,000 ($100,000 gain forgiven)

4. May 29, 2026 (7 years) – Taxpayer's basis in investment is $150,000 (an additional $50,000 gain is forgiven)

5. December 31, 2026 ("First Recognition Date") – Taxpayer pays tax on $850,000 deferred gain (less if the fair market value of property has declined)

6. May 29, 2039 (20 years) ("Second Recognition Date") – Taxpayer sells investment for $2,000,000 and there is no tax on the $1,000,000 of appreciation

4. How Does a Taxpayer Invest Gain to Obtain OZ Benefits?

A taxpayer must invest eligible capital gains directly in a QOF. Eligible gains must be treated as capital gain, recognized for federal income tax purposes before January 1, 2027 and not arise from a sale or exchange with a related party (using a 20% test). Eligible gains only include those which are subject to U.S. federal income tax.

A taxpayer cannot invest in a partnership that invests in the QOF. This adds some complexity in structuring QOFs. An investor can invest capital gain in a QOF by buying an interest in a QOF from another person. An investor can invest more than capital gain in a QOF but only the capital gain portion is eligible for QOZ benefits. Gains recognized by individuals, C corporations, REITs, S corporations, and partnerships are eligible for investment in a QOF.

An individual investor has 180 days to invest capital gains in a QOF.[10] The 180 days commences on the day the gain is recognized for federal income tax purposes. Note that the 180-day period is 180 calendar days and not six months.

There are some special rules regarding gains from investments in pass-through entities that can help extend the time to invest. A partnership can defer the gain until the end of its tax year which would frequently be December 31. If the partnership has gain on January 2, it could potentially

[10] IRC § 1400Z-2(a)(1)(A).

defer that gain until December 31 and then the partner would have 180 days after December 31 to invest in a QOF. In addition, the Regulations permit taxpayers to begin the 180-day period on the due date of the entity's tax return, not including any extensions.[11] As an example, if a partnership sells an asset on January 2, 2020 resulting in capital gain, a taxpayer could have until September 10, 2022 to invest capital gain in a QOF (180 days after March 15, 2021). It may be advisable to modify existing partnership agreements and LLC operating agreements to inform partners about sales so that they can choose the start of the 180-day period and to provide a process for the general partner to get consent prior to making election to defer gain at the partnership level.

Similarly, capital gains from regulated investment companies and REITs now can be invested as of the date of the dividend distribution or within 180 days of the end of the entity's taxable year.[12] Special rules also apply to the time to invest Section 1231 gains. Section 1231 applies to depreciable property used in a trade or business that is held for more than one year. The Regulations provide that Section 1231 gains are eligible gains. Typically, 1231 gains and losses are netted for a tax year. A taxpayer does not have to have overall Section 1231 net gains and Section 1231 gains are not reduced by Section 1231 losses for the purpose of determining the amount that can be invested in a QOF.[13] If a taxpayer had a $1,000,000 1231 gain on February 1, 2020, the taxpayer could invest the $1,000,000 in QOF, even if the taxpayer had a 1231 capital loss on December 1, 2020. The Regulations also start the 180-day period on Section 1231 gains on the date of the sale or exchange, as opposed to the end of the taxpayer's year which is a change from the proposed Regulations.

The IRS also established a special rule for gain recognized from installment sales. Capital gains on installment sales can be deferred even if the installment sale occurred before December 22, 2017. The Regulations allow an eligible taxpayer to elect to choose the 180-day period to begin on either: (a) the date a payment under the installment sale is received, or (b) the last day of the taxable year the eligible gain under the installment method would be recognized.[14] This could result in a single 180-day period commencing on the last day of the taxable year or multiple 180-day periods commencing with each installment payment.

Taxpayers will make the election to defer capital gains on Form 8949, Sales and Other Dispositions of Capital Assets by attaching to the investor's tax return for the year that gain is deferred.

5. <u>QOZ</u>

What is a QOZ? A QOZ must be a low-income census tract ("LIC") as LIC is defined under the New Markets Tax Credit Program ("NMTC Program") or in limited situations a census tract adjacent to a LIC. The Act gave the governors of the 50 states, the five possessions of the United States, and the mayor of the District of Columbia the ability to designate a portion of the LIC's in their jurisdiction as QOZ. QOZ were designated in 2018 and are fixed and cannot change under

[11] Treas. Reg. § 1.1400Z2(a)-1(c)(8)(iii)(B).
[12] Treas. Reg. § 1.1400Z2(a)-1(a)(7)(ii).
[13] Treas. Reg. § 1.400Z2(a)-1(b)(2)(iii).
[14] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(viii)(A).

the current law. The QOZ had to be a qualified LIC or a contiguous census tract where income was less than 125% of the contiguous LIC, provided that the number of contiguous tracts could not exceed 5% of the tracts designated in a state.[15] Only 25% of the eligible tracts could be designated. However, states or territories in which there are fewer than 100 LICs could designate up to 25 LICs. In addition, all of Puerto Rico is a QOZ.[16]

The Department of Treasury certified the final QOZ on June 14, 2018. There were 8,762 tracts designated of which 1,858 are in rural areas. There are 1.6 million businesses and 24 million current jobs in the existing QOZ. QOZ are home to 35 million individuals. 56% of the residents of QOZs are minorities, compared to 38% in the United States overall. Many states included specific set asides for Indian land resulting in 294 OZs that contain Indian land. The average QOZ has a median family income equal to only 59% of area median income. On the average the unemployment rates in QOZs is 14.4%, which is about 10% higher than the country as a whole.

Do not assume what constitutes a QOZ. In part, because the 2010 census was used to determine tracts that could be designated and in part because of how the decisions were made, some designations are not immediately obvious. In Minnesota, the area south of the regional airport is a QOZ. It includes a "distressed" area called The Mall of America, the largest shopping center in the United States. So, if you are evaluating a transaction, do not immediately conclude that it cannot be a QOZ. Also, be careful in concluding that an area is a QOZ because many distressed areas were not designated.

To determine if a location is in a QOZ, enter the address on CDFI's NMTC Public Viewer.[17] There is a Guide on the CDFI website on how to use the mapping tool.[18]

6. QOF

A Qualified Opportunity Fund ("QOF") is an investment vehicle organized for the purpose of investing in qualified OZ property ("QOZ Property").[19] A taxpayer needs to invest capital gain in a QOF to obtain OZ tax benefits. A QOF must be organized as a corporation or partnership, including a limited liability company taxed as a partnership, to invest in QOZ Property. Gains invested must be capital gains, excluding gains from sale of inventory, sale of assets held for sale to customers in the ordinary course of business, depreciation recapture, Section 291 gains and gains from straddles. Note that QOF investments must take the form of equity not debt. However, a taxpayer's investment in a QOF can be secured.

QOFs can be organized in any state or the District of Columbia. However, if the QOF is investing in property in a U.S. territory, the QOF may also be organized in that territory. In addition, a QOF

[15] Rev. Proc. 2018-16.
[16] https://caribbeanbusiness.com/puerto-rico-gov-signs-opportunity-zones-development-act/.
[17] https://www.cims.cdfifund.gov/preparation/?config=config_cdfi.xml.
[18] Visualizing Designated Qualified Opportunity Zone Census Tracts.
[19] Code § 1400Z-2(d)(1).

may be organized under the law of a federally recognized Indian tribe, noting however, that the QOF will be subject to federal income tax notwithstanding any tribal ordinance provisions.

A QOF self-certifies using IRS Form 8996.[20] The IRS doesn't approve the self-certification of the QOF, but the agency reserves the power on audit to determine if the self-certification is accurate. Choosing the month that the QOF starts is vitally important because any investments done before the start date designated on the Form 8996 are not eligible. The Form 8996 is also filed annually by the QOF.

The QOF must have 90% of its assets invested as equity in eligible QOZ Property and it must meet that test twice each year. The 90% test is done six months after the QOF begins and again at the end of its tax year. If a calendar year QOF starts on May 30, the tests will occur on November 30 and December 31. If the QOF starts in September, the first test will be on December 31, so there will only be 90 days to meet the 90% test. A QOF may exclude contributed capital from the 90% test for six months after it is received from investors, provided that it is held in cash, cash equivalents or short-term debt instruments.

In applying the 90% asset test, the QOF can use the asset values that are reported on the QOF's applicable financial statement for the taxable year (as defined in Treas. Reg. § 1.475(a)-4)[21], or the unadjusted cost basis of the assets.[22] For leased property, value may be determined based on the net present value of lease payments at the beginning of the lease or based on applicable financial statements.[23]

A QOF can invest directly in QOZ Property or indirectly invest through a QOZ Business ("QOZB") that is a corporation, partnership or LLC. There are differences in the rules that apply to direct and indirect investments that need to be carefully analyzed before deciding how to structure an investment.

7. <u>QOZ Property</u>

QOZ Property can be stock, partnership (or LLC) interests or business property in an OZ. A QOF can acquire an equity interest in a business corporation, a partnership, or limited liability company taxed as a partnership or acquire and directly hold qualified opportunity zone business property described below. Stock or partnership interests must be issued after December 31, 2017. When a QOF invests in any existing entity, the entity must be a Qualified Opportunity Zone Business (QOZB) and it must continue to qualify as a QOZB for substantially all of the holding period of the stock or partnership interest.[24] This means that during 90% of the QOF's holding period for the stock, the corporation or partnership is a QOZB. If the entity is newly formed, the entity need

[20] https://www.irs.gov/pub/irs-drop/rr-18-29.pdf; https://www.irs.gov/pub/irs-pdf/f8996.pdf
[21] Treas. Reg. § 1.1400Z2(d)-1(b)(4).
[22] Treas. Reg. § 1.1400Z2(d)-1(b)(2).
[23] Treas. Reg. § 1.1400Z2(d)(1)(b)(4).
[24] Treas. Reg. § 1.1400Z2(a)-1(b)(5).

not be a QOZB on the date stock is issued, but it must be organized for the purpose of being a QOZB.[25] Note that a QOF cannot invest in another QOF.

Stock does not qualify if the issuing corporation redeemed a significant amount of its stock within the two-year period beginning one year before the issuance to the QOF or redeemed any stock from the QOF or a party related to the QOF within a four-year period beginning two years before the issuance to QOF.[26]

QOZ Property is important because a QOF must have 90% of its assets invested in QOZ Property. Subject to certain exceptions, cash is not QOZ Property and can cause a QOF to fail the 90% test.

8. QOZ Business Property

There are a number of requirements for property to be classified as QOZ business property ("QOZBP").[27] First, it has to be acquired after December 31, 2017. It also has to be acquired from an unrelated party based on a 20% test, provided that an exception exists for certain leased property. Real property either has to be new construction or it has to be substantially improved to be QOZBP. The substantially improved test is a very high bar because the rehabilitation must equal the adjusted tax basis of the property.[28] The substantial rehabilitation test must be met within a 30-month period that commences after the acquisition of the property. Where real property is acquired, the adjusted basis is calculated on the adjusted basis of the building and not the land.[29] In addition, personal property used in a QOZB can be counted towards meeting the substantial improvement test, even if not included in the basis of the building. The Regulations contain an example of a hotel where the QOF purchases linens, furniture, and exercise equipment that is included when calculating whether the hotel was substantially improved.[30] The Regulations changed the rules so that buildings can be aggregated for purposes of meeting the substantial improvement test if they are within a single opportunity zone or a series of contiguous OZ and located on land described in a single deed or if they are located on contiguous parcels and they meet certain operational requirements.[31] If treated as a single property, then the amount of basis required to be added will be the total basis of each building and additions to the property are aggregated to determine satisfaction of the substantial improvements test.[32]

Tangible property acquired by purchase must have its original use in a QOZ commencing with the QOF or QOZB or be substantially improved in order to qualify for OZ benefits.[33] The "original use" of tangible property commences when the property is placed in service in the QOZ for the purposes of depreciation or amortization. The property located in the QOZ must not have been

[25] IRC § 1400Z-2(d)(2)(B)(i)(II).
[26] Treas. Reg. § 1.1400Z-2(d)-1(c)(2).
[27] IRC § 1.1400Z-2(d)(3).
[28] Treas. Reg. 1.1400Z2(a)-1(b)(1).
[29] Rev. Rul. 2018-29(b)(4).
[30] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iii)(D)(1).
[31] Treas. Reg. § 1.1400Z2(d)-1(b)(4)(v)(A)-(C).
[32] Treas. Reg. § 1.1400Z2(d)-1(b)(4)(v)(D).
[33] Treas. Reg. § 1.1400Z2(d)(2).

previously depreciated or amortized by a taxpayer other than the QOF or QOZB. However, a building that has been vacant for at least three (3) years after the date the area was designated as a QOZ will satisfy the original use requirement. In addition, a property that was vacant when the QOZ was established only has to have been vacant for one calendar year beginning on a date prior to the date on which the QOZ in which the property is located is listed as a QOZ and the property has remained vacant through the date on which the property was purchased by the eligible entity.[34] Vacant property is property that is significantly unused meaning that more than 80% of the building or land, as measured by the square footage or usable space, is not being used.[35] All real property composing a brownfield site, the land and buildings, will be treated as meeting the original use test, if within a reasonable period, the QOF or QOZP, makes investments so that the brownfield site meets basic safety standards.[36] In addition, improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property for the amount of the unadjusted cost basis of the improvements.[37]

The original use of tangible property in the QOZ commence with a QOF is not applicable to land. Likewise, land does not need to be substantially improved, provided that land that is held for investment and not used in a trade or business would not qualify.[38] This means that agricultural and other businesses operated using raw land might qualify. However, the use of the land entirely for the production of an agricultural crop without new capital investment or increase of any activity or output of the land would not qualify. The IRS declined to provide specific guidance about what constituted a substantial improvement of farmland. The Regulations do provide an example that concluded the conversion of a farm from hog and pig farming to sheep and goat farming constituted a substantial improvement.[39]

For projects straddling a QOZ, the Regulations include both a square footage test and an unadjusted cost test to determine if a project is primarily in a QOZ, and provide that parcels or tracts of land will be considered contiguous if they possess common boundaries, and would be contiguous but for the interposition of a road, street, railroad, stream or similar property. Tracts are not contiguous if they only touch at a common corner.[40] Importantly, the final regulations also extend the straddle rules to QOF's and QOZB's with respect to the 70-percent use test.

The final regulations provide that both the land and structures in a Brownfield site redevelopment are considered to be original use property as long as the QOF or QOZB make investments into the Brownfield site to improve its safety and compliance with environmental standards.[41]

[34] Treas. Reg. § 1.1400Z2(d)-2(b)(3).
[35] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(iii).
[36] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(iv).
[37] Treas. Reg. § 1.1400Z2(d)-2(b)(3).
[38] Treas. Reg. § 1.1400Z2(f)-1(c)(3), Example 4.
[39] Treas. Reg. § 1.1400Z2(f)-1(c)(3), Example 5.
[40] Treas. Reg. § 1.1400Z2(d)(3).
[41] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(c)(iv).

9. QOZB

A QOF can invest in a QOZB. For each tax year, a QOZB must meet the following requirements:

(1) At least 50% of the gross income must be derived from the active conduct of a trade or business in the QOZ.

(2) A substantial portion of the intangible property must be used in the active conduct of a trade or business in the QOZ.

(3) Less than 5% of the aggregate unadjusted bases of the property of the business is attributable to non-qualified financial property.

A QOZB is a trade or business in which substantially all of the tangible property owned or leased by the business is QOZBP.[42] There is a special rule for tangible property owned by a QOZB. Tangible property that ceases to be QOZBP shall continue to be QOZBP for the lesser of five years or the date that the QOZB disposes of the tangible property.[43] The Regulations define a trade or business for purposes of § 1400Z-2 as a trade or business within the meaning of Section 162 of the Code.[44]

Note that the QOZ Program is particularly confusing because of the different percentages that are used to define "substantially all". Substantially all is used in three different contexts. First, substantially all (70%) of a QOZB's tangible property owned or leased must be QOZBP.[45] Second, tangible property is QOZBP if, among other things, substantially all (90%) of the QOF's or QOZB's holding period for such property,[46] substantially all (70%) of the use of such property is in a QOZ.[47] Third, for substantially all (90%) of the time a QOF owns an interest in a subsidiary, the subsidiary must be a QOZB.

The rules are also somewhat confusing because the definition of substantially all can differ based on whether the property is owned directly by a QOF or owned indirectly through a corporation or partnership investment in a QOZB. For direct ownership by a QOF, the substantially all test is 90% but for indirect ownership the substantially all test is 70%. So a QOF must meet the 90% asset test but 70% of the tangible property owned by a QOZB must be QOZBP.

It is important to consider the timing of capital contributions for the 70% "substantially all" test. Assume that a QOF plans to invest $6,000,000 in an LLC on February 1, 2019 and $6,000,000 on February 1, 2020. The LLC has $4,000,000 of property that it owned prior to January 1, 2018 (not eligible because acquired before January 1, 2018). The LLC has taken the steps to have the

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[42] Treas. Reg. § 1.1400Z2(d)-1(d).
[43] Treas. Reg. § 1400Z-2(d)(3)(B).
[44] Treas. Reg. § 1.1400Z2(d)(2).
[45] Treas. Reg. § 1.1400Z2(d)-2.
[46] Treas. Reg. § 1.1400Z2(d)-2(d)(3).
[47] Treas. Reg. § 1.1400Z2(d)-2(d)(4).

$6,000,000 meet the reasonable working capital requirements.[48] The LLC fails the substantially all test because the $6,000,000 working capital is only 60% of the LLC's $10,000,000 of assets. The QOF investment in the LLC would not qualify, so the QOF fails the 90% test. The solution is for the QOF to invest at least $11,200,000 up front and have a plan to use the working capital so that 70% of its assets would qualify ($11,200,000 ÷ 16,000,000 = 70%).

A QOZB cannot be a sin business, which includes massage parlors, hot tub facilities, golf courses and country clubs, suntan facilities, racetracks or other facilities used for gambling or any store the principal business of which is the sale of alcoholic beverages off premises.[49] The NMTC Program has similar rules, so guidance under the NMTC Program can be helpful when determining if a business is a sin business.[50] A QOZB cannot lease more than a de minimis amount of its property to a sin business. In determining whether a QOZB is a sin business, less than five percent of the assets and gross income can be received from the sin business. The Regulations provide an example of a QOF that owns stock in a corporation that operates a hotel in a QOZ. The hotel operates a spa that provides massages. Because less than 5% of the hotel's gross income, net rentable square feet and value were attributable to the spa, the spa did not prevent the hotel from qualifying as a QOZB.[51]

For an operating business to qualify as a QOZB, at least 50% of the income of a QOZB must be derived from the active conduct of its business in the QOZ.[52] There are three safe harbors and a facts and circumstances test that can be used to determine if 50% of the income is derived from the active conduct of a trade or business.[53]

The first safe harbor is based on hours and requires that at least 50% of the services performed (based on hours) for the business by its employees and independent contractors (and employees of independent contractors) be performed within the QOZ. This test is intended to address businesses located in a QOZ that primarily provide services. The percentage is based on a fraction, the numerator of which is the total number of hours spent by employees and independent contractors (and employees of independent contractors) performing services in a QOZ during the taxable year, and the denominator of which is the total number of hours spent by employees and independent contractors (and employees of independent contractors) in performing services for the business during the taxable year. The example provided for this safe harbor is a software developer where a majority of the work done by the business' employees and independent contractors was done on the business' campus located in a QOZ.

The second safe harbor is similar to the first and is based on amounts paid by the trade or business for services performed by employees and independent contractor in the QOZ. The example for this safe harbor provides that while the majority of employees worked a majority of the hours at a

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[48] See the discussion of the working capital safe harbor below.
[49] IRC § 1400Z-2(d)(3)(B).
[50] Treas. Reg. § 1.1400Z2(d)-1(d)(4).
[51] Treas. Reg. § 1.1400Z2(d)-1(d)(4)(iv), Example 1.
[52] IRC § 1400Z-2.
[53] Treas. Reg. § 1.1400Z2(d)-1(d)(3).

service center outside the OZ, the fact that the business paid 50% of its total compensation to employees for software development services within the OZ satisfied the 50% requirement.

The third safe harbor is a conjunctive test involving tangible property and management or operational functions performed in a QOZ, permitting a trade or business to use its overall situation to meet the requirements. The Regulations provide that a trade or business may satisfy the 50% gross income requirement if: (1) the tangible property of the business that is in a QOZ and (2) the management or operational functions performed for the business in the QOZ are each necessary to generate 50% of the gross income of the trade or business. The example provided is a landscaping business where the landscaper's headquarters are in a QOZ, its officers and employees manage the daily operations of the business (occurring within and outside the QOZ) from its headquarters, and all of its equipment and supplies are stored within the headquarters facilities or elsewhere in the QOZ. The management activity and the storage of equipment and supplies in the QOZ are each necessary to generate 50% of the gross income of the trade or business.

A QOZB that does not meet any of the other safe harbor tests may meet the 50% requirement based on a facts and circumstances test. Based on all the facts and circumstances, at least 50% of the gross income of a trade or business must be derived from the active conduct of a trade or business in the QOZ to meet the test. A PO Box in the OZ is not considered as a positive factor in determining whether a business satisfies the 50% test.

Note that the IRS has indicated that merely leasing property under a triple-net-lease is not the active conduct of a trade or business.[54] However, triple net leased real estate might qualify as an active trade or business if services are provided by the building owner.

Another requirement is that less than 5% of the aggregate unadjusted basis of property owned by a QOZB can be nonqualified financial property ("NQFP") which is debt, stock, partnership interest, swaps, futures contracts, warranties, annuities, and similar property.[55] NQFP does not include cash equivalents, debt instruments with a term of 18 months or less, reasonable amounts of working capital and accounts receivables in the ordinary course of business. As a result of this requirement, a financial institution is not a QOZB.

There is a safe harbor for reasonable working capital.[56] A QOZB can have up to 31 months to spend the cash and have the cash count as eligible property if it has a written plan for spending working capital, a schedule for spending the working capital, and it substantially complies with that schedule. This is particularly helpful for acquisition and rehabilitation of existing buildings because the QOZB will need substantial resources to complete the required rehabilitation. First, the written designation for planned use of working capital now includes the development of a trade or business in a QOZ, as well as the acquisition, construction, and/or substantial improvement of tangible property. This should permit working capital plans to cover payroll, inventory, and other reasonable costs during startup. The working capital safe harbor is doubled to 62 months for star-

[54] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iii)(B).
[55] Treas. Reg. § 1.1400Z2(d)-1(d)(4).
[56] Treas. Reg. § 1.1400Z2(c)-1(d)(4).

up businesses since it can take start-ups longer to commence operations. In addition, the working capital safe harbor is extended 24 months to 55 months when a project is delayed due to a disaster and the OZ is located in a Federally declared disaster area. Second, exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action, if an application for the action is completed during the 31-month period. The Regulations also make it clear that businesses can benefit from multiple overlapping or sequential applications of the 31-month working capital safe harbor, provided that each application independently satisfies all of the requirements.

The Regulations also establish an additional 62-month safe harbor for start-up businesses. To qualify for a maximum 62-month working capital safe harbor period, a start-up business must receive multiple cash infusions during its start-up phase.[57] The initial cash must be covered by a working capital safe harbor plan and the subsequent cash infusion must be covered by a separate working capital safe harbor and the subsequent cash infusion must form an integral part of the working capital plan that covered the initial cash infusion.

The Regulations provide that for purposes of determining whether a substantial portion of a QOZB's intangible property is used in a trade or business, the term "a substantial portion" means 40%.[58]

Inventory does not fail to be used in a QOZ solely because the inventory is in transit to or from a facility in the QOZ. The distance traveled by the inventory when in transit or the fact that the inventory is briefly warehoused while in transit does not make it ineligible.[59]

10. Leased Property

Leased tangible property can qualify as QOZ Property.[60] For purposes of the 90% asset test and the 70% substantially all requirement, leased tangible property may be treated as QOZ business property if:

(1) The lease is entered after December 31, 2017.

(2) Substantially all (70%) of the use of the leased tangible property must be in a QOZ during substantially all (90%) of the holding period of the QOZBP by the QOF or QOZB.

(3) The lease is a market rate lease determined under Treas. Reg. § 1.482.

However, leases from state and local governments and tribes need not be at market rate. Leases that are not between related parties are presumed to be at market rate. The property subject to the

[57] Treas. Reg. § 1.1400Z2(d)-1(b).
[58] Treas. Reg. § 1.1400Z2(d)-1(d)(3).
[59] Treas. Reg. § 1.1400Z2(d)-2(d)(4)(vii).
[60] Treas. Reg. § 1.1400Z2(d)-2(a).

lease does not have to meet the original use requirement, so it may have been previously leased to other lessees. In addition, the lessee does not have to substantially improve the leased property.

As note4d above, triple-net-leases do not qualify. The Regulations do not provide a lot of guidance as to what level of activity is necessary for a rental property to qualify as a trade or business. The Regulations contain an example concluding that a QOZB that owns a three-story mixed-use building, and (i) leases one floor of the building under a triple-net lease, (ii) leases the other two floors under leases that are not triple-net-leases, and (iii) has employees with offices located in the building who meaningfully participate in the management and operations of building, is engaged in an active trade or business with respect to the entire leased building solely for purposes of the opportunity zone trade or business requirement.

A QOF or QOZ Business can lease property from a related party provided that:

(1) The lessee cannot make a prepayment to the lessor or a related person relating to a period of use of the leased tangible property of more than twelve months.

(2) If the original use of the tangible personal property does not commence with the lessee, the lessee QOF or QOZB must also acquire by purchase other tangible property that qualifies as QOZBP with a value at least equal to the value to the leased property with thirty months of possessing the leased property or by the end of the term of the lease for the lease property whichever is earlier.[61]

The Regulations also provide that if the leased property (other than unimproved land) was subject to a plan, intent or expectation, that the property would be purchased by the QOF for other than its fair market value, it cannot be QOZ Property.[62] This is designed to prevent the use of leases to avoid the substantial improvement requirement.

The Regulations provide for the following two methods for the annual valuation of leased property. First, valuation may be based on an applicable financial statement valuation method if the QOF or QOZ business has applicable financial statements (within the meaning of Treas. Reg. § 1.475(a)-4(h)) prepared in accordance with GAAP.[63] Under the alternative valuation method, the value of leased property is determined based on a calculation of the present value of the leased tangible property based on the present value of the payments to be made under the lease using a discount rate determined under 26 U.S.C. § 1274(d)(1).[64]

There are two favorable rules for leased property: A lease does not have to satisfy the original use requirement and the property does not have to substantially improve the property.

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[61] Treas. Reg. § 1.1400Z2(d)-2(c)(3).
[62] Treas. Reg. § 1.1400Z2(d)-2(c)(4).
[63] Treas. Reg. § 1.1400Z2(d)-1(b).
[64] Treas. Reg. § 1.1400Z2(b)-1(c)(6).

11. Noncompliance

One item of good news is that the noncompliance with the 90% test does not appear to be a cliff test. Instead, noncompliance, absent reasonable cause, results in a monthly financial penalty. The penalty equals the shortfall of asset value below the 90% requirement multiplied by the underpayment rate in the Internal Revenue Code.[65] However, because the calculation is based on financial statements that may not be prepared monthly, additional guidance needs to be issued to clarify how the penalty will be calculated. No guidance is provided as to what constitutes reasonable cause for failing the 90% test.

12. Treatment of Dispositions

The general rule is that the deferred capital gain is recognized when the investment is sold or exchanged, or, if earlier, December 31, 2026.[66] However, the taxpayer generally does not have to recognize gain on the appreciation of an investment in a QOF held for at least ten years until the earlier of disposition or December 31, 2047.[67]

The appreciation exclusion only applies to the portion of the investment that represents deferred capital gain; the investor is not eligible for the exclusion after 10 years to the extent the taxpayer's investment in the QOF exceeds the amount of rollover capital gain. An investor that has held a qualifying interest in a QOF for at least 10 years may generally exclude *all* gain realized on an underlying sale of any asset by a QOF or by a lower-tier partnership or S corporation QOZB, except to the extent the gain arises from the sale of inventory in the ordinary course of business.[68]

Although the statute seemed to apply exclusively to a direct disposition of a QOF interest, the ten-year exclusion of appreciation applies to assets owned by a QOF that is a partnership, so an investor can exclude gain reflected on Schedule K-1 attributable to the QOF's sale of QOZ Property directly or through a QOZB. This may be true even when the taxpayer has held the QOF interest for ten years but the QOF has not held the interest in the asset for ten years.

Certain events referred to as "inclusion events" end deferral of gain. In general, an event is an inclusion event, if, and to the extent that—

[65] Treas. Reg. § 1.1400Z2(f)-1.
[66] IRC 1400Z-2(b)(1); Treas. Reg. § 1.1400Z2(b)-1(b).
[67] Treas. Reg. § 1.1400Z2(c)-1(c).
[68] Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(A).

1. The event reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment;

2. An eligible taxpayer receives property in the event with respect to its qualifying investment and the event is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF;

3. An eligible taxpayer claims a loss for worthless stock or otherwise claims a worthlessness deduction with respect to its qualifying investment; or

4. A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.[69]

Inclusion events are detailed in the Regulations[70] and include:

1. Termination or liquidation of the QOF or QOF owner.

2. A QOF's check-the-box election resulting in a change in tax classification of the QOF.

3. Transfer of an investment in a QOF by gift or a transfer incident to a divorce.

4. A distribution of property by a QOF partnership to a partner to the extent the distributed property has a fair market value in excess of the partner's basis in the qualifying investment.[71]

A transfer by reason of the death of the taxpayer is not an inclusion event and the QOF holding period does not start over.[72] Note, however, that the decedent's beneficiaries step into the decedent's shoes and there is no step-up in basis. In addition, a contribution by an investor of an interest in a QOF to a partnership as a non-taxable contribution under Section 721 is generally not an inclusion event.[73]

An election to defer gain may not be made with respect to gain from a sale or exchange if an election previously made with respect to the sale or exchange is in effect. If a taxpayer disposes of all or part of its interest in a QOF prior to December 31, 2026, a new deferral election can be made with respect to the taxpayer's investment of an amount equal to the gain from the inclusion event in either the original QOF or a new QOF within 180 days of the inclusion event. A gain arising from an inclusion event is eligible for the deferral election even if the taxpayer retains a portion of its qualifying investment in the QOF after the inclusion event.[74] The 180-day period

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[69] Treas. Reg. § 1.1400Z2(b)-1(c)(1).
[70] Treas. Reg. § 1.1400Z2(b)-1(c)(2)(i), -1(c)(3)(ii).
[71] Treas. Reg. § 1.1400Z2(b)-1(c)(6)(iii).
[72] Treas. Reg. § 1.1400Z2(b)-1(c)(4).
[73] Treas. Reg. § 1.1400Z2(b)-1(c)(6)(ii)(B).
[74] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(iv).

for gain from an inclusion event begins on the date of the inclusion event and the taxpayer's holding period for the new QOF investment begins on the date of the new investment is made.[75]

13. Interim Gain/Distributions

Proceeds received by the QOF from the sale or disposition of (1) QOZBP, (2) QOZ stock, and (3) QOZ partnership interests are treated as QOZ property for purposes of the 90% investment requirement, so long as the QOF reinvests the proceeds received from the distribution, sale, or disposition of such property during the twelve-month period beginning on the date of such distribution, sale, or disposition and continuously holds the proceeds in cash, cash equivalents, and debt instruments with a term of eighteen months or less.[76] The proceeds do not have to be invested in the same type of investment. The QOF reinvestment period can also be extended if failure to meet the twelve-month deadline is attributable to delay in government action the application for which is complete.[77] While the reinvested proceeds will permit the investment to continue to qualify, the QOF and its investors will not avoid recognition of gain of the sale or the disposition of assets under general income tax principles.

The 0% basis an investor has in its QOF interest only applies to the deferred capital gain that is invested in the QOF; however, such investor is able to include its share of the debt (determined under the regular partnership tax rules) in the tax basis of its qualifying QOF interest and such investor can receive a distribution of refinancing proceeds from such QOF without triggering recognition of the deferred capital gain or otherwise disqualifying the investment from OZ benefits, provided that the cash distribution is not greater than the investor's tax basis in the QOF. However, debt-financed distributions by a QOF will not get these benefits if made within two years of the date the taxpayer invested in the QOF.[78] In addition, even after two years, the disguised sales rules could cause gain recognition.

14. Combination With Other Programs

QOZ benefits can potentially be combined with other programs. Although OZ benefits may be combined with NMTC Program incentives, the fact that the investment in NMTC transactions are typically structured as loans may limit its effectiveness. In addition, Community Development Entities ("CDE") may have to modify their applications for NMTC to permit equity investments rather than loans. When applying for an allocation of NMTC, most CDEs describe their activities as lending to be qualified active low-income businesses. Another issue is that OZ and the NMTC zones are not identical. While the governors selected QOZ from LIC (as defined in the NMTC Program), only 25% of the eligible tracts could be selected for OZ. One good thing about combining investments in Qualified Opportunity Zones and NMTC is the seven-year term required for the NMTC matches the seven-years required to get the 15% forgiveness of gain under the QOZ

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[75] Treas. Reg. § 1.1400Z2(a)-1(b)(7)(iv)(D).
[76] Treas. Reg. § 1.1400Z2(f)-1(b).
[77] Id.
[78] Treas. Reg. § 1.1400Z2(a)-1(c)(6)(iii)(A)(2).

Program. So, an NMTC and OZ may work together, but there may be some complications in structuring the transaction.

QOZ benefits may also be combined with historic credits. One benefit is that any qualified historic property in a QOZ should be eligible to receive HTC and QOZ benefits. However, the five-year HTC compliance period is less than the ten years required to exclude appreciation on an investment under QOZ. There are also some issues with the master tenant structure frequently used in historic transactions that could make these transactions more complex.

Some LIHTC projects may work well with the QOZ. The LIHTC investor would provide equity to a QOF that could then invest in a tax credit partnership which would be the QOZB. The 15-year holding period under LIHTC is longer than the 10-year holding period required to exclude tax on appreciation required by the QOZ Program. However, a taxpayer would still have to make a tax payment on December 31, 2026, so transactions will need to be structured so that the taxpayer has the cash to pay tax liability even when the QOF has not disposed of the asset. Another problem is that the amount of the rehabilitation requirement under the OZ Program is much higher than under the LIHTC Program. The timing to complete the rehabilitation also differs, but this should be an easy issue to structure. Under LIHTC, the rehabilitation requirement must be met in 24 months and under the OZ Program it is 30 months. It should also be noted that the 20% related party test under the OZ Program is less than the 50% related party test under the LIHTC Program. The traditional investor in LIHTC transactions and the investors in OZ are not a perfect match. Banks are the investors in a substantial portion of LIHTC transactions, partly due to Community Reinvestment Act credit. However, most banks do not have capital gains because they are limited in making equity investments. The investors in OZ will likely be mutual funds, managed investment companies, and high-net worth individuals. It will take some education to get a new group of investors to get involved in the complex LIHTC program.

Sometimes an investor's negative capital account can result in tax liability when an investor seeks to exit a LIHTC project after the end of the tax credit compliance period. The OZ Program may help to solve this problem if the transaction is properly structured. If the QOF investment has lost value, IRC Section 7701(g) can apply allowing the investor to step up its Year 15 QOF basis to at least the amount of the nonrecourse debt. The step-up to at least the amount of debt should allow the OZ-LIHTC investor to avoid some or all of the exit taxes that would otherwise be due, although there are possible issues relating to the treatment of depreciation recapture.

15. 1031 Exchange v. OZ

While OZ resembles the 1031 exchange program, there are some significant differences including when the gain is recognized. Using a 1031 exchange, a taxpayer recognizes gain when the taxpayer disposes of the acquired asset. Under an OZ investment, a taxpayer recognizes gain on its original capital gain on the earlier of December 31, 2026 or disposition of the asset. The type of property that qualifies for deferral also differs. Under the 1031 Program, investments can only be in real property and under the OZ Program, investments can be in real property, personal property, and operating businesses. Qualifying OZ investments must be in a QOZ and qualifying 1031 property

can be located anywhere in the U.S. The amount of the investment is also different. Under the 1031 Program, a taxpayer has to invest all sales proceeds in the replacement property and under OZ, a taxpayer only has to invest the capital gain. The 1031 program does not generally have the same related party limitations that apply to the OZ Program. The two programs also differ as to how gain is treated on the death of the taxpayer. There is a step-up in basis under Section 1031 so that gain is permanently eliminated if the exchanging party holds the replacement property until death. Finally, there is no forgiveness of any of the gain under a 1031 transaction and in an OZ transaction, 15% of the gain is forgiven and appreciation is forgiven.

16. State Tax Laws

State tax laws will impact benefits available under OZ, so it is important to review the applicable state law when structuring a transaction. Note that these laws are changing rapidly and the following descriptions may no longer be applicable. The New York State Department of Taxation and Finance said that deferral or exclusion of gains will flow through to New York taxpayers (with a caveat that New York could consider decoupling from the federal provision). On the other hand, California does not intend to conform to the deferral and exclusion of capital gains reinvested or invested in QOFs except for certain investments in green technology and affordable housing. Some states are adopting specific legislation to address OZ. OZ benefits increase if the state tax law conforms to federal law.

Several state tax laws could be involved in determining a taxpayer's liability based on where gain occurred and where the OZ fund is located. It is important to consider:

(1) The state where original gain was realized,

(2) The state where the QOF is organized,

(3) The state of residency of the taxpayer.

17. Types of Transactions

A wide variety of transactions may be financed with OZ benefits. The simplest and most common to date is the real estate transaction that was already planned and the proposed purchaser uses capital gains invested in a QOF for the purchase. The options are, however, much more diverse. The OZ program could potentially be used for an agricultural operation in a rural area that improves production through capital improvements. Some proposals involve private ownership of infrastructure facilities that are leased to governmental entities. The largest potential upside may be from a successful start-up located in an OZ because of the exclusion of appreciation on investments held for more than ten years.

Examples of possible OZ investments include affordable and market rate housing, hotels, office buildings, retail centers, health clinics, start-up tech companies and restaurants. A company's branch office would not qualify unless set up as a separate legal entity. A convenience store would

not qualify if a large portion of its revenue was from the sale of liquor. A non-profit corporation will only qualify if it establishes a taxable subsidiary or the transaction is structured as a lease to the non-profit.

18. Securities Issues

Capitalization of QOFs involves an offering of securities and requires a traditional securities exemption analysis. This requires consideration of the Securities Act of 1933, as amended, and state securities ("blue sky") laws. When reviewing compliance with applicable securities laws, the attorney needs to be aware of the three kinds of offerings: (1) registered, (2) exempt, and (3) illegal. Obviously, an attorney working with a QOF wants to avoid the third option. The most common exemptions used will probably be Regulation D – Rule 506(b) or Rule 506(c). The exemption under Rule 506(b) is available for unlimited dollars if the following criteria are satisfied:

(1) There are a maximum of 35 non-accredited investors.

(2) There is no general solicitation or advertising.

(3) As to accredited investors, there must be reasonable belief of the investor's accredited status.

(4) Any non-accredited investors must provide Rule 502 information.

In contrast, while both Rules permit unlimited dollars, only accredited investors can participate in an investment meeting the Rule 506(c) exemption and their accredited status must be verified. Unlike Rule 506(b), Rule 506(c) permits general solicitation and advertising. Both Rules 506(b) and 506(c) prohibit "bad actors". A bad actor is a person who engages in certain bad acts listed in Rule 501(d)(1), including crimes or felonies by the individual involving securities within the last ten years. An individual subject to certain SEC or USPS orders or who has been suspended or expelled from membership in a national securities exchange is also a "bad actor".

Investment in a QOF is subject to the securities laws antifraud provisions which include an untrue statement of material fact, or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. It is important to evaluate what information has been provided (or not provided) to prospective investors. Best practices in disclosure documents become even more critical in QOF context.

19. Entity Formation Issues

QOFs typically involve the traditional entity formation issues at issue for all equity investments, as well as some unique to QOFs. The organizational documents may include an operating agreement, offering memorandum, investor rights agreement, and buy-sell agreement. Topics for negotiation among the parties include:

(1) The management structure of the QOFs, including the appointment and removal of management, their scope of authority, and compensation;

(2) Approval rights of the investors, particularly of decisions that could adversely impact the tax benefits; and

(3) Investor rights, including rights of first refusal and participation rights.

Agreements will have to detail approvals over events that (1) disqualify the QOF, or (2) result in QOF investors not meeting 5, 7, or 10 year holding periods. The agreements will have to address consequences for failure to qualify as a QOF, including who bears the penalties for non-compliance.

Not all investors in a QOF need to be seeking QOF benefits. Some investors may invest funds that are not capital gains simply because they like the proposed investment. Drafting agreements for this type of QOF will be particularly difficult since some investors will be motivated primarily by the investment holding requirements and others may prefer to dispose of interests when deemed best to maximize profits.

20. Conclusion

This paper sets out some of the basic principles of QOFs and QOZs, and the investments that qualify for such treatment. Although the time frame for making investments in QOZ is short if maximum benefits are to be achieved without clear regulatory guidance, the QOZ Program got off to a slow start. As the regulatory landscape has become clearer, it is likely that more investments will materialize.