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IRS Releases Latest Round Of Opportunity Zone Regulations: Where Do We Stand Now?

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As part of the Tax Cuts and Jobs Act, Congress enacted two companion provisions designed to encourage investment and economic growth in certain low-income communities. First, Sec. 1400Z-1 paved the way for nearly 9,000 such low-income communities to be designated as "qualified opportunity zones" (QOZs). In turn, Sec. 1400Z-2 offers three federal income tax incentives to a taxpayer who invests in a business located within one of these zones: (1) the temporary deferral of capital gains, to the extent the gains are reinvested into a "qualified opportunity fund" (QOF); (2) the partial exclusion of previously deferred gains when certain holding period requirements in a QOF are met; and (3) the permanent exclusion of post-acquisition gains from the sale of an investment in a QOF held longer than 10 years.

While Sec. 1400Z-2 teases a tantalizing menu of tax breaks, the statutory language was, to put it kindly, vague and confusing. As a result, taxpayers were initially uncertain of how to meet the various investment requirements to achieve the promised tax benefits.

On Oct. 19, 2018, the IRS published proposed regulations providing much of the direction taxpayers had been seeking. And while those regulations represented a giant step forward in understanding how to implement an opportunity zone project, many questions remained. Last week, the IRS sought to address many of those questions by publishing a second set of proposed regulations. These regulations provide much needed clarity on conducting an operating business within a QOZ, while also providing additional flexibility for QOFs that wish to purchase raw land, lease property to be used in their business, receive ongoing inflows of invested capital, or dispose of assets and reinvest the proceeds in replacement property. In addition, the latest regulations provide relief for those investors who do not sell their interest in a QOF after ten years, but rather cause the QOF to sell its assets.

This discussion will take a look at the newly-issued proposed regulations from the perspective of the manner in which they address questions raised by the initial round of proposed regulations. First, of course, we'll need to get up to speed on what the statute and the *original* proposed regulations had to say, so we'll begin by examining what we knew BEFORE last week's release of additional guidance. When we discuss the original guidance, I will *not* layer on changes made by the newest round of regulations within that discussion; rather, I'll save those changes for the final analysis of *only* the latest guidance so that we can track the evolution of the opportunity zone rules.

By all means, if you were very comfortable with how opportunity zones worked prior to last Wednesday, then feel free to skip ahead to the section titled "New Proposed Regulations." But if you're in need of a refresher, I'd encourage you to give the entire article a read.

What We Knew Before Last Week: Statute and October Regulations

Opportunity Zone Life Cycle, In General

Sec. 1400Z-2 entails a specific process, complete with critical definitions, deadlines, and quantitative tests that must be satisfied before the promised tax benefits become a reality. The life cycle of an opportunity zone investment can be represented at a high level as follows:

A taxpayer realizes gain taxed as capital gain --> The taxpayer reinvests the gain within 180 days into a QOF and defers the gain for the year of sale --> The QOF conducts business, either directly by holding qualified opportunity zone business property (QOZBP) or indirectly by holding QOZ stock or a QOZ partnership interest --> After holding the interest in the QOF for five years, the taxpayer excludes 10% of the original deferred gain --> After an additional two years, another 5% of the original deferred gain is excluded --> Any remaining deferred gain is recognized on Dec. 31, 2026 unless an "inclusion event" occurs prior to that date --> After holding the interest in the QOF for a total of ten years, the taxpayer may sell the investment in the QOF -- or, in limited circumstances -- the QOF may sell its assets -- at any time before 2048 and the taxpayer exclude the gain resulting from the sale.

As you'll notice, the opportunity zone life cycle is rife with acronyms. Let's establish a brief glossary before we dig in any deeper:

QOZ: qualified opportunity zone. These are the designated areas in which a business must be conducted for any of the tax benefits to come to fruition.

QOF: qualified opportunity fund. A taxpayer who wishes to defer eligible gain must invest an amount equal to that gain into a QOF within 180 days of the sale. A QOF can be a C corporation, S corporation, or partnership.

QOZP: qualified opportunity zone property. A QOF must conduct a business in a QOZ, either directly or indirectly. This standard is tested every six months, and at each testing date, at least 90% of the assets of the QOF must be QOZP. QOZP can either be qualified opportunity zone business property (discussed below), or an interest in a subsidiary corporation or partnership that conducts a qualified opportunity zone business (also discussed below).

QOZB: qualified opportunity zone business. A QOF can conduct a business directly, or through a corporate or partnership subsidiary. If done through a subsidiary, the subsidiary must meet the definition of a QOZB.

QOZBP: qualified opportunity zone business property. As discussed more fully below, QOZBP is property purchased after 2017 from an unrelated party, and, in general, either 1. the "original use" of the property in the QOZ begins with the QOF or QOZB, or 2. the QOF or QOZB "substantially improves" the property. The latest regulations allow additional flexibility by allowing for leased property to qualify as QOZBP.

Initial Round of Proposed Regulations

Eligible Gain

The immediate benefit provided by Sec. 1400Z-2 is the deferral of "eligible gain" that is reinvested into a QOF within 180 days of the sale or exchange that gives rise to the gain. Eligible gain is gain that:

- Is "treated as capital" for federal income tax purposes;
- Would be recognized for federal income tax purposes before Jan. 1, 2027; and
- Does not arise from a sale or exchange with a related party (a 20% direct or indirect relationship either before or after the sale).

The use of the term "treated as capital gain" is important. It allows for gain arising from the sale of a Sec. 1231 asset — which by definition is not a capital asset but the net gain from which is taxed as capital gain — to qualify as eligible gain. Any depreciation recapture taxed as ordinary income under Secs. 1245 and 1250, however, is not eligible gain.

Eligible Taxpayers

Any taxpayer that realizes eligible gain for federal tax purposes may elect to defer that gain. These taxpayers include individuals, C corporations (including RICs and REITs), partnerships, S corporations, and trusts and estates.

If a partnership or S corporation realizes eligible gain, it has a choice: It may elect to defer that gain at the entity level, or it may pass the gain through to its owners, who are then free to make their own decision on deferral.

If a partnership or S corporation elects to defer the eligible gain, the deferred gain is not included in the distributive share of the owners and does not increase the owners' basis in the entity. When some or all of the deferred gain is subsequently recognized by the entity under the rules of Sec. 1400Z-2, the gain is included in the distributive share of the owners and increases the owners' basis at that time.

Ex. A, B, and C each own a one-third interest in PRS, a partnership. In 2019, PRS realizes eligible gain of $90,000. If PRS elects to defer the gain, no amount of the $90,000 gain is allocated to A, B, or C, and the basis of A, B, and C in PRS is not increased. If the partnership does not elect to defer the eligible gain, the gain is included in the distributive share of the partners and immediately increases each partner's basis in the partnership. Each partner, in turn, may then elect to defer some or all of the eligible gain allocated from the partnership, but only if the sale by the partnership giving rise to the gain was to a taxpayer unrelated to the partner.

Ex. Assume the same facts as in the previous example, only PRS does not elect to defer the eligible gain realized in 2019. As a result, each of A, B, and C is allocated $30,000 of gain, and each partner increases his or her basis in PRS at that time. Any or all of A, B, or C may then elect to defer the gain at the individual level, provided all the requirements of Sec. 1400Z-2 are met.

Timing of Reinvestment

A taxpayer that wishes to defer eligible gain must reinvest the gain into a QOF within 180 days from the date of the sale or exchange that gives rise to the gain.

In the case of a partnership or S corporation that realizes eligible gain but does not elect to defer that gain, choosing instead to allocate the gain to its owners, the 180-day period with respect to the owners' eligible gains generally does not begin on the date of sale. Instead, it begins on the last day of the entity's tax year.

Ex. A is a one-third partner in PRS, a calendar-year partnership. On Jan. 8, 2018, PRS realizes $90,000 of eligible gain. PRS elects not to defer the gain and includes $30,000 in A's distributive share. A does not receive the Schedule K-1 reflecting the $30,000 of gain until March 12, 2019, a date well after the 180-day period beginning on the Jan. 8, 2018, sale date. For the purposes of determining A's 180-day period, however, the period begins on Dec. 31, 2018, the last day of PRS's tax year. This extends A's period for reinvestment until June 29, 2019.

Alternatively, a partner or shareholder may elect to treat the 180-day period with respect to the owner's distributive share of that gain as being the same as the entity's 180-day period. This would permit an owner to accelerate his or her reinvestment into a QOF.

Ex: Assume the same facts as in the previous example A may elect to treat the 180-day period with respect to his $30,000 of gain from PRS as beginning on Jan. 8, 2018, the date of the partnership sale.

A taxpayer elects to defer eligible gain by filing Form 8949, *Sales and Other Dispositions of Capital Assets* with their tax return for the year of sale.

A taxpayer is not required to reinvest the entire *proceeds* from the sale or exchange giving rise to the eligible gain; rather, to defer the full amount of eligible gain, the taxpayer must reinvest only the gain amount. Thus, unlike a Sec. 1031 exchange, a taxpayer reinvesting in a QOF can both take cash off the table *and* defer the full amount of gain resulting from the sale.

Ex: A holds a building with an adjusted tax basis of $1 million and FMV of $2 million. If A does a Sec. 1031 exchange with B, receiving replacement property with an FMV of $1.7 million and $300,000 of cash, A must pay tax on the $300,000 of gain under Sec. 1031(b) and thus may defer only $700,000 of gain. Alternatively, if A sells the building for $2 million of cash, A can retain $1 million of cash, reinvest the remaining $1 million into a QOF within 180 days, and defer the full $1 million of gain.

If a taxpayer invests more than the eligible gain amount into a QOF, the taxpayer is treated as having made two separate investments. The first represents only the investment of eligible gain for which a deferral election has been made. The second consists of all other amounts. The subsequent exclusion provisions (discussed later in this article) apply only to the investment of the eligible gain.

Ex. A realizes $100,000 of eligible gain on June 7, 2019. On June 23, 2019, A invests $150,000 into a QOF and elects to defer the $100,000 of gain. A is treated as having made two separate investments into the QOF; the first is the $100,000 of deferred gain that will be eligible for future tax benefits under Sec. 1400Z-2, and the second is a $50,000 investment that represents the amount invested in excess of the eligible gain. This second investment is not eligible for future tax benefits under Sec. 1400Z-2 but rather is subject to general tax principles.

Recognition of Previously Deferred Gains

Previously deferred eligible gain must be included in income at the earlier of:

- The date on which the interest in the QOF is sold or exchanged (or any other "inclusion event"), or
- Dec. 31, 2026.

The amount of gain included in gross income is determined by subtracting the taxpayer's basis in the investment in the QOF (for these purposes, it is zero before being increased as the 5 and 7-year holding periods are met) from the lesser of:

- The original amount of deferred gain, or
- The FMV of the interest in the QOF on the recognition date.

If a taxpayer sells an interest in a QOF that was previously subject to a gain deferral election, the taxpayer may in turn make a second election to further defer the recognition of the original deferred gain, if the taxpayer reinvests the gain amount within 180 days in the same or another QOF. This opportunity for a second deferral applies only when the taxpayer sells the entire interest in the QOF.

When previously deferred gain is included in income — either upon sale of the investment in the QOF or on Dec. 31, 2026 — the gain has the same attributes in the year of inclusion that it would have had if tax on the gain had not been deferred. These attributes include those taken into account by Secs. 1(h), 1222, 1256, and any other applicable provisions of the Code. As a result, a taxpayer seeking to defer gain must consider the possibility that tax rates on capital gains could be significantly higher than the 23.8% maximum rate imposed today.

Qualified Opportunity Funds

A taxpayer may defer eligible gain only if, within 180 days of the sale or exchange, some or all of the gain is reinvested into a QOF. A QOF is a special-purpose entity that effectively acts as a conduit, achieving the policy goal of ensuring that invested capital is ultimately employed in a business located within a QOZ.

A QOF may be organized as a corporation or partnership and may be newly formed or a preexisting entity. A QOF does not need to be located within a QOZ.

A QOF must self-certify that it is a QOF by filing Form 8996, *Qualified Opportunity Fund*, with its tax return for each year the entity intends to operate as a QOF. In the first tax year the entity intends to operate as a QOF, the entity has the option of specifying the first month it wants to be a QOF. If no month is specified, then the first month of the entity's initial tax year as a QOF is treated as the first month that the entity is a QOF. Designation of the initial year and month as a QOF is critical, because any eligible gain invested by a taxpayer into an entity before the entity's first month as a QOF is not eligible for deferral.

As stated earlier, a taxpayer that elects to defer gain by reinvesting that gain into a QOF takes a basis in the QOF interest of zero. If a taxpayer invests money in a QOF and does not make an election to defer eligible gain with respect to that investment — or if the taxpayer invests more than the eligible gain amount into a QOF — this investment is treated as a separate investment in the QOF, and the taxpayer's basis in that investment in the QOF is determined under general tax principles. Only investments attributable to deferred gains are eligible for the five-, seven-, and 10-year holding period exclusion provisions.

The 90% test

A QOF must hold at least 90% of its assets in QOZP (the "90% test"), determined by the average of the percentage of QOZP held in the fund, as measured on:

- The last day of the first six-month period of the tax year of the QOF, and
- The last day of the tax year of the fund.

If an entity's self-certification as a QOF is effective for a month other than the first month of the entity's tax year, then in the QOF's first year, the first six-month period begins on the first day the entity is designated as a QOF, but only if its tax year is longer than six months.

If an entity's first month as a QOF is the seventh month of its tax year or later, there is only one testing date for the year: the last day of the QOF's tax year.

Ex. PRS, a calendar-year partnership, self-certifies that it intends to operate as a QOF beginning September. 1, 2019. Because there are not six months in PRS's initial tax year as a QOF, there is only one measurement date for purposes of the 90% test: Dec. 31, 2019.

If a QOF has an applicable financial statement, then the value of each asset for purposes of the 90% test is the value of that asset as reported on the QOF's applicable financial statement for the relevant reporting period. If a QOF does not have an applicable financial statement, the value of each asset of the QOF for purposes of the 90% test is the QOF's cost of the asset.

If a QOF fails to meet the 90% test for any year, the QOF must pay a penalty for each month it fails to meet the requirement. No penalty is imposed, however, if it is shown that the failure to satisfy the 90% test was due to reasonable cause. The proposed regulations do not provide examples of reasons for failing to satisfy the 90% test that would satisfy the reasonable-cause exception.

Qualified Opportunity Zone Property

By requiring that a QOF hold 90% of its assets in the form of QOZP, Sec. 1400Z-2 ensures that the QOF is investing in a business located within a QOZ. There are three types of QOZ property:

- QOZBP,
- QOZ stock, or
- QOZ partnership interests.

The first option permits a QOF to operate a business directly. The latter two options permit a QOF to operate a business indirectly through a subsidiary.

Qualified Opportunity Zone Business Property

A QOF that operates a business directly — and not through a subsidiary — must hold 90% of its assets as QOZBP. To meet the definition of QOZBP, the property must satisfy a number of statutory and regulatory requirements.

1. Only tangible property used in a "trade or business" counts toward the 90% test.
2. The property must have been purchased by the QOF from an unrelated party after Dec. 31, 2017. This ensures that the QOF is making a new investment into a QOZ.
3. As a general rule, the original use of the property within the QOZ must begin with the QOF (the "original use" requirement). This would prove problematic to a QOF that planned, for example, to purchase and renovate a building within a QOZ, because the building will have already existed within the QOZ. The statute and initial proposed regulations provide an exception to this original-use requirement, however, if a QOF "substantially improves" personal or real property acquired within the QOZ. Property is substantially improved by the QOF if during

any 30-month period beginning after the date of acquisition of the property, the QOF spends as much to improve the property (measured by additions to basis) as the QOF's original basis in the property at the beginning of the 30-month period.

The original proposed regulations clarify that if a QOF purchases a building located on land wholly within a QOZ, the "substantial improvement" requirement is measured only by reference to the QOF's original basis in the building; as a result, the QOF is not required to separately substantially improve the land upon which the building is located. In addition, Rev. Rul. 2018-29, published at the same time as the proposed regulations, clarifies that when land is purchased with a building that is substantially improved, the original-use requirement for the land is ignored. This will result in the value of both the land and the improved building being treated as QOZBP for purposes of the 90% test.

Ex. A QOF acquires land and a building in a QOZ on Jan. 1, 2019, for $10 million; $4 million of the basis is allocated to the land, with the remaining $6 million of basis allocated to the building. Because the land and building were previously located within the QOZ, they do not satisfy the original-use requirement. On Jan. 1, 2019, the QOF begins to improve the building, and those improvements add $6 million to the basis of the building during the 30-month period beginning Jan. 1, 2019. The building has been substantially improved, and both the land and the building will be treated as QOZBP.

The combination of the original-use requirement and the mandate that QOZBP be purchased after Dec. 31, 2017, by a QOF from an unrelated party poses problems to a taxpayer that owned property in a QOZ prior to Dec. 31, 2017. To illustrate, assume a taxpayer had begun construction on a hotel in a QOZ prior to 2018. That taxpayer would not satisfy the requirement that QOZBP be acquired after 2017. If the taxpayer sells the property to a QOF, however, for the taxpayer to defer any gain on the sale — and for the QOF to be able to count the property as QOZBP — the taxpayer and the QOF cannot be related, and as a result, the taxpayer cannot own more than 20% of the QOF after the sale. Giving up this much equity may be unpalatable to a taxpayer, and any alternative to a sale — for example, a lease of the property from the taxpayer to the QOF, with the QOF then "substantially improving" the lease — would create additional challenges for both the QOF and the taxpayer that the initial proposed regulations did not adequately address. As we'll see below, however, the latest round of proposed regulations address the lease issue, providing some flexibility along with safeguards intended to prevent abuse.

Finally, to meet the definition of QOZBP, during "substantially all" of the QOF's holding period for the tangible property, "substantially all" of the use of the tangible property must be in a QOZ. The definition of "substantially all" for these purposes was reserved in the original proposed regulations.

QOZ Stock and Partnership Interests

Alternatively, a QOF may satisfy the 90% test by conducting a business in a QOZ through a subsidiary by holding QOZ stock or a QOZ partnership interest.

Stock in a corporation is treated as QOZ stock if:

- It was acquired by a QOF after Dec. 31, 2017, directly from the corporation or through an underwriter, solely for cash;
- At the time the stock was issued, the corporation was a qualified opportunity zone business (QOZB) or, in the case of a new corporation, was organized for purposes of being a QOZB; and
- During "substantially all" of the QOF's holding period for the stock, the corporation is a QOZB.

Similarly, an interest in a partnership is treated as a QOZ partnership interest if:

- It was acquired by a QOF after Dec. 31, 2017, directly from the partnership solely for cash;
- At the time the partnership interest was issued, the partnership was a QOZB, or in the case of a new partnership, was organized for purposes of being a QOZB; and
- During "substantially all" of the QOF's holding period for the partnership interest, the partnership is a QOZB.

If corporate stock or a partnership interest held by a QOF satisfies these requirements, then all of the assets of the subsidiary partnership or corporation are considered QOZ property for purposes of applying the 90% test to the QOF. There is no prohibition on a QOF investing in a preexisting corporation or partnership, but from a practical perspective, if the subsidiary owns significant assets that were acquired prior to 2018, it will be difficult for the subsidiary to satisfy the 70% test (discussed below).

Qualified Opportunity Zone Business

When a QOF operates a business through a subsidiary, for all of the assets of the subsidiary to count toward the 90% test, at the time the subsidiary's stock was issued or its partnership interest was acquired by the QOF, and during "substantially all" of the QOF's holding period for the stock or partnership interest in the subsidiary, among other requirements, the subsidiary must meet the definition of a QOZB. To be a QOZB, the subsidiary must satisfy a "70% test," an "income-and-assets test," and a "qualifying-business" test.

The 70% test

At least 70% of all of the tangible property owned or leased by the trade or business of the subsidiary must meet the definition of QOZBP. As previously discussed, QOZBP is property that meets the following requirements:

- The property must have been acquired by the subsidiary by purchase or lease after Dec. 31, 2017;
- The original use of the property in the QOZ must have commenced with the subsidiary, or in the alternative, the subsidiary must substantially improve the property; and
- During "substantially all" of the subsidiary's holding period of the tangible property, "substantially all" of the use of the tangible property was in a QOZ.

The income-and-assets test

For each tax year, a QOZB must satisfy the following requirements set forth by Sec. 1397C(b).

- At least 50% of the gross income must be derived from the active conduct of a trade or business in the QOZ (the "50%-of-income test");
- A substantial portion of the intangible property must be used in the active conduct of a trade or business in the QOZ (the "intangible test"); and
- Less than 5% of the aggregate unadjusted bases of the property of the trade or business is attributable to nonqualified financial property (the "5%-of-assets test").

Nonqualified financial property includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property. Excluded from the definition of nonqualified financial property are reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

The 5%-of-assets test would prove problematic for QOZBs that receive a large influx of investment capital but need time before they can convert that capital into tangible property. To illustrate, a QOF may invest significant cash into a subsidiary partnership that intends to build affordable housing. Absent an exception, while the subsidiary partnership is seeking approvals and beginning construction, the cash would be treated as nonqualified financial property. Fortunately, the proposed regulations contain such an exception in the form of a safe harbor.

Working capital assets are considered reasonable — and thus are not treated as nonqualified financial property — if the amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ. In addition, there must be a written schedule consistent with the ordinary startup of a trade or business for the expenditure of the working capital assets within 31 months of the business's receipt of the assets; and the working capital must actually be used in a manner that is substantially consistent with the written plan.

If these requirements are met, any gross income earned on the working capital throughout the 31-month period counts toward the satisfaction of the 50%-of-income test. Likewise, throughout the entire 31-month period, the business is treated as having satisfied the intangible test.

Ex. In 2019, Taxpayer H realized $10 million of capital gains and within the 180- day period invested $10 million in QOF. QOF immediately acquired from Partnership P a partnership interest in P, solely in exchange for $10 million of cash. P immediately placed the $10 million in working capital assets, which remained in working capital assets until used. P had written plans to acquire land in a QOZ on which it planned to construct a commercial building. Of the $10 million, $4 million was dedicated to the land purchase, $5 million to the construction of the building, and $1 million to ancillary but necessary expenditures for the project. The written plans provided for purchase of the land within a month of receipt of the cash from QOF and for the remaining $5 million and $1 million to be spent within the next 30 months on construction of the building and on the ancillary expenditures. All expenditures were made on schedule, consuming the $10 million. During the tax years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent amounts in the working capital assets, and P's work in process as the building was constructed.

P met the three requirements of the safe harbor. P had a written plan to spend the $10 million received from QOF for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ. P had a written schedule consistent with the ordinary startup of a business for the expenditure of the working capital assets. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary startup of a business. Therefore, the $4 million, the $5 million, and the $1 million are treated as reasonable in amount. Because Phad no other gross income during the 31 months at issue, 100% of P's gross income during that time is treated as derived from an active trade or business in the QOZ for purposes of satisfying the 50%-of-income test. For purposes of satisfying the intangible test, during the period of land acquisition and building construction, a substantial portion of P's intangible property is treated as being used in the active conduct of a trade or business in the QOZ.

The disqualified-business test

A QOZB may not be a business described in Sec. 144(c)(6)(B) (a so-called sin business). This includes:

- Any private or commercial golf course;
- Country club;
- Massage parlor;
- Hot tub facility;
- Suntan facility;
- Racetrack or other facility used for gambling; or
- Any store, the principal business of which is the sale of alcoholic beverages for consumption off the premises.

Tax Benefits Resulting from an Investment of Eligible Gain into a QOF

A taxpayer who invests eligible gain within 180 days into a QOF is eligible for four distinct tax benefits, provided the taxpayer holds the investment in the QOF for at least 10 years. The first three benefits relate to the reinvested eligible gain, while the final benefit relates to gain realized on the disposition of the investment in the QOF.

To illustrate the application of these benefits, assume that on April 21, 2019, A sells publicly traded stock in which A has a basis of $1 million for $2 million, realizing $1 million of eligible gain. On May 9, 2019, A reinvests $1 million into a QOF.

Tax benefit No. 1: Deferral of eligible gain

A may elect to defer the recognition of the $1 million of gain. If she makes this election, A will not report the gain on her 2019 tax return. A's basis in the QOF is zero.

Tax benefit No. 2: Exclusion of 10% of the deferred gain

If A holds the investment in the QOF for five years (May 9, 2024) the basis of the investment is increased by 10% of the deferred gain, or $100,000. Stated another way, 10% of the deferred gain is now permanently excluded and will never be recognized.

Tax benefit No. 3: Exclusion of additional 5% of the deferred gain

If A holds the investment in the QOF for an additional two years, the basis of the investment is increased by an additional 5% of the deferred gain, or $50,000. As a result, 15% of the deferred gain is now permanently excluded.

The seven-year basis increase creates a sense of urgency for investing in opportunity zones. For investments made in 2020, it will be impossible to achieve the seven-year holding period prior to the deferred gain's being automatically triggered on Dec. 31, 2026. Thus, to maximize the tax benefits available under Sec. 1400Z-2, taxpayers should reinvest deferred gain into a QOF before Dec. 31, 2019.

Recognition of deferred gain

Any remaining deferred gain must be recognized by Dec. 31, 2026 unless an inclusion event occurs prior to that date. The amount of gain to be recognized is determined by subtracting the taxpayer's basis in the investment — zero before being increased in years 5 and 7, if applicable— from the lesser of (1) the amount of eligible gain originally deferred, or (2) the FMV of the investment in the QOF on Dec. 31, 2026.

If *A* continues to hold the investment in the QOF at Dec. 31, 2026, at a time when the investment has an FMV of $1.4 million, *A* must recognize the remaining $850,000 of deferred gain. This is the lesser of the FMV of the investment ($1.4 million) or the original deferred gain ($1 million), less *A's* basis in the investment ($150,000, zero before being increased at the five- and seven-year anniversaries). *A's* then increases her basis in the investment by the amount of deferred gain recognized, or $850,000. A's basis in the investment in the QOF is now $1,000,000.

It is important to note that if a taxpayer holds an interest in a QOF until the end of 2026, the deferred gain becomes due without a liquidating event. Thus, it is critical that taxpayers reinvesting deferred gain into a QOF plan accordingly and set aside cash to pay the 2026 tax liability.

Tax benefit No. 4: Exclusion from gain on the sale of a QOF interest held longer than 10 years

If a taxpayer holds an interest in a QOF for 10 years that is attributable to a previous election to defer eligible gain, upon the sale of that investment, the basis of the investment is treated as being equal to its FMV. In simpler terms, this means that no gain is recognized upon the sale of the investment in the QOF. This represents the ultimate benefit offered by Sec. 1400Z-2: the ability to exclude all gain upon the subsequent disposition of an interest in a QOF that has been held for 10 years. To receive the benefit of the tax-free gain, however, the taxpayer must sell the investment in the QOF before Jan. 1, 2048.

In 2035, *A* sells her investment, with a basis of $1 million, for $6.4 million. Because the investment has been held longer than 10 years, the basis of the investment is treated as being equal to the sales price of $6.4 million, and no gain is recognized on the appreciation of the investment after Dec. 31, 2026.

It is important to remember that only gain from the sale of an investment in a QOF that was originally attributable to the investment of eligible gain for which a deferral election was made is eligible for the gain exclusion upon sale of the investment.

Ex. Assume the same facts as in the previous examples, except in addition to the investment of $1 million of eligible gain for which a deferral election was made into the QOF, A also invested an additional $500,000 into the QOF that was not related to eligible gain. Upon the subsequent sale of the investment in the QOF in 2035, only the gain attributable to the $1 million investment is eligible for the basis increase and related gain exclusion.

New Proposed Regulations

While the October regulations were certainly helpful, they created no shortage of additional questions. Proposed regulations issued last week, however, addressed and answered ten of those questions.

Question #1: What is a "trade or business" for purposes of the opportunity zone incentive?

Q: QOZBP must be used by a QOF or QOZB in a "trade or business." Section 1400Z-2 and the original proposed regulations, however, did not define a trade or business for these purposes. And while the term "trade or business" would appear to be a rather important one in applying the tax law, nowhere in the Code or regulations will you find its definition. In fact, there are several *different* "trade or business" standards, depending on which provision of the statute is being applied.

The highest standard of a trade or business is found under Section 162, the provision that grants taxpayers the ability to claim a deduction for the ordinary and necessary operating expenses incurred while conducting a "trade or business." The Supreme Court has established that to qualify as a Section 162 trade or business, the activity can't be a sporadic amusement, but rather must be entered into for profit and conducted with continuity and regularity.

If the intention is that the activity of a QOF or QOZB must rise to the level of a trade or business under the meaning of Sec. 162, the relevant authority — to say nothing of the recently finalized regulations under Sec. 199A — would present a problem for property rented on a triple-net basis. The IRS has historically viewed these types of rentals as an investment rather than a Sec. 162 trade or business; as a result, if a QOF or QOZB constructs a building that is rented, for example, to Walmart on a triple-net basis, the IRS may take the position that the building is not used in a trade or business and should not count toward the 90% or 70% test. So what, exactly, is a "trade or business" for purposes of Section 1400Z-2?

A: Proposed Regulation 1.1400Z2(d)-1(c)(4)(ii) requires that a QOF conduct a trade or business *within the meaning of Section 162*. Proposed Regulation 1.1400Z2(d)-1(d)(2)(ii) requires the same of a QOZB. As discussed above, this presents a problem in the context of property rented on a triple-net basis. The regulations further provide that the ownership and operation (including leasing) of real property is the active conduct of a trade or business. The regulations state, however, that "merely entering into a triple-net lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business." As a result, a QOF or QOZB should structure any lease arrangement to avoid being classified as a triple-net lease.

Question #2: How do we decide when and how we can defer Section 1231 gains?

Q: The original proposed regulations made clear that gain from the sale of a Sec. 1231 asset is eligible to be reinvested into a QOF because it is "treated as capital gain." Sec. 1231 requires a netting process, however; only net Sec. 1231 gains, after reduction for Sec. 1231 losses, are treated as capital gain. This netting process poses a problem in several ways. First, if a partnership recognizes a Sec. 1231 gain, the character of that gain is determined only at the partner level, after the partner has netted the gain with any Sec. 1231 losses. How, then, can a partnership reinvest Sec. 1231 gain if it has not yet been determined that the gain will be treated as capital gain?

In addition, assume an individual sells a Sec. 1231 asset for a gain of $1 million on Jan. 2, 2019. The 180-day window begins on that date. Assume further that on Dec. 5, 2019, the same individual sells a second Sec. 1231 asset, this time recognizing a loss of $1.2 million. The taxpayer has no net Sec. 1231 gain for the year, but that has not been revealed to be the case until after the 180-day window related to the Jan. 2 sale has expired.

A: The newest round of regulations directly address this issue. Prop. Reg. Section 1.1400Z2(a)-1(b)(2)(iii) provides that because we can't know whether an isolated Section 1231 gain will result in *net capital gain* until that gain has been netted with all other Section 1231 gains and losses of the taxpayer during the year, we have to wait until the *end of the tax year*, when the netting process is complete and a net gain is revealed, before we can defer that net gain by contributing it to a QOF. To solve the issue with timing, the regulations provide that the 180-day reinvestment period begins on the *last day of the tax year*.

Thus, in our example above featuring the individual, that taxpayer would not be permitted to immediately reinvest the $1 million of Section 1231 gain recognized on Jan. 2, 2019. Instead, the individual would have to wait out the entire year, and net the gain with the $1.2 million of loss recognized on Dec. 5, 2019. Because the net result is a loss, rather than capital gain, there would be no eligible gain to be reinvested. If the Dec. 5, 2019 transaction generated only a $400,000 loss, however, the individual would have net capital gain for the year of $600,000, all of which could be reinvested into a QOF, with the 180-day period for reinvestment *beginning on December 31, 2019*.

Presumably, these same rules would apply in our partnership example above. The partnership would wait until the end of its year and be eligible to reinvest any net Section 1231 gain for the year, *even though, had that gain been passed out to the partners, it may have resulted in a net loss at the partner level when netted with the partner's Section 1231 losses from other sources.*

Question #3: What is the definition of "substantially all" for purposes of qualified opportunity zone stock, partnership interest, and property?

Q: The term "substantially all" is used five times in Section 1400Z-2.

- In order for property to qualify as QOZBP, for "substantially all" of the QOF's or QOZB's holding period of the property, "substantially all" of the use of the property must be in a QOZ.
- A QOZB must hold "substantially all" of its property as QOZBP.
- If a QOF holds an interest in a subsidiary entity, in order for that entity to qualify as an QOZB, it must meet the definition of a QOZB for "substantially all" of the QOF's holding period of the subsidiary's stock or partnership interest.

The original proposed regulations defined only #2, as 70%. The remaining definitions were reserved. So what does "substantially all" mean for these purposes?

A: This most recent round of regulations defined #1 and #3 as well. For the first "substantially all" of #1 and the "substantially all" of #3 (the holding period terms), the term means 90%. For the second "substantially all" in #1, the term means 70%.

As a result, a QOF can hold 90% of its assets in a QOZB, but in turn, that QOZB must hold 70% of its assets as QOZBP, but in order to be QOZBP, for only 90% of the QOZB's holding period of the property it must be used in a QOZ for 70% of the time. If you were to do the math (you won't), a QOF operating a business through a subsidiary QOZB could pass the 70% test while having as little as 40% of QOZBP in a QOZ.

Question #4: Is raw land considered QOZBP?

Q: When a QOF or QOZB acquires land, the land cannot satisfy the requirement that the original use of QOZBP begin in the QOZ with the taxpayer. This casts doubt on whether the value of land is counted toward the 90% or 70% test.

Rev. Rul. 2018-29 provided some clarity by stating that when a QOF or QOZB acquires land and a building together, provided the building is substantially improved within a 30-month period, the original-use requirement does not apply to the land on which the building is located. Thus, the value of both the land and the building will meet the definition of QOZBP. But what if a QOF or QOZB acquires only raw land and then constructs a new building? Can the conclusion reached in Rev. Rul. 2018-29 be expanded to exclude the land from the original-use requirement even when it is not purchased in conjunction with a building that is subsequently substantially improved? Neither Rev. Rul. 2018-29 nor the regulations address such a scenario.

If land purchased separately is not QOZBP because of the failure to satisfy the original-use test, how can raw land be substantially improved? What types of improvements increase the basis of raw land such that the 30-month test could be met?

A: The newly issued proposed regulations provide tremendous relief in this regard. the regulations state that a QOF or QOZB can purchase raw land, and even though the land cannot possibly satisfy the original use test, that land *does not need to be substantially improved*.

This could lead to potential abuses where a QOF engages in land speculation by purchasing raw land, opting not to construct a structure on the land, and sell the land after ten years tax-free. Remember, however, that as discussed above, a QOF or QOZB must *conduct a trade or business*, and holding raw land is not a trade or business. But what if a QOF puts a nominal structure on raw land, say...a hot dog stand. Could the QOF buy 100 acres it views as undervalued, operate a tiny hot dog stand on the land in order to satisfy the trade or business standard, and then ten years later, sell the land tax-free while all the while contributing nothing more to the residents of a QOZ then occasional indigestion?

Question #5: Can a QOF or QOZB lease property and have it meet the definition of QOZBP?

Q: The initial proposed regulations provided that a QOF must "purchase" QOZBP, while a QOZB could "purchase or lease" QOZBP. It was unclear, however, how a lease satisfied the purchase or original-use requirement if the leased property was already located within a QOZ. In addition, it was unclear how a QOF could "substantially improve" a lease.

A: The latest round of proposed regulations address this issue in detail. First and foremost, both a QOF and QOZB may now lease property. For leased property to meet the definition of QOZBP, however, the lease must be entered into AFTER December 31, 2017 and its terms must be arms-length. In general, two VERY favorable rules apply to leased property:

1. A lease does not need to satisfy the "original use" requirement, and
2. The QOF or QOZB is not required to "substantially improve" the lease.

Thus, a QOF can generally lease a building that has long existed in a QOF and need not substantially improve the property. This would enable a start-up company to lease its office space and have that lease meet the definition of QOZBP.

If a lease is between a QOF (or QOZB) and a related party, however, there are additional safeguards put into place by the new regulations. First, the lessee cannot make a prepayment on the lease relating to a period of use that exceeds 12 months. Then, in an exception to the general rule that the original use test does not apply to leased property, in order for property leased from a related party to count as QOZBP, the property must either 1. satisfy the original use requirement, or 2. during the 30-month period beginning with the inception of the lease, the QOF or QOZB must acquire other tangible QOZBP with a value equal to the value of the leased property. There is an important distinction here: the QOF or QOZB does not need to substantially improve the lease in any way, it simply must acquire other QOZBP with a value equal to the value of the lease, and that property can be completely unrelated to the leased property. For these purposes, leased property can be valued at either the value on an applicable financial statement, or by taking a present value of all lease payments on the date the lease is entered into. Be warned, however, that the latter value is determined on the date the lease is entered into and is used for the entire length of the lease; thus, this alternative valuation would not accurately capture a downturn in the market that reduces the value of the leased property.

Finally, if at the time a lease for real property is entered into (with a related or unrelated party) there is a plan or expectation for the leased property to be purchased by the QOF or QOZB for an amount other than the FMV determined at the time of purchase, *the property is not QOZBP*.

Question #6: What types of events will trigger deferred gain during an investors holding period in a QOF?

Q: Gain that is deferred upon reinvestment into a QOF will be recognized on the earlier of 1. December 31, 2026, or 2. the date on which the investment is "sold or exchanged." The original proposed regulations reserved paragraphs intended to describe those transactions in addition to a "sale or exchange" that will trigger recognition of previously deferred gains. So what do the new regulations have to say about the issue?

A: The new regulations -- at Prop. Reg. Section 1.1400Z(b)-1(b) -- establish a general principle that deferred gain must be recognized any time a taxpayer either 1) reduces their direct equity investment in the QOF, or 2. "cashes out" a portion of their investment in the QOF by receiving a distribution of property with a FMV in excess of the taxpayer's basis in the QOF.

This latter group of inclusion events includes any distribution from a QOF corporation or partnership that exceeds the owner's basis and is thus taxed as a sale or exchange under either Section 301, 731 or 1368. These types of inclusion events will trigger deferred gain on a dollar-for-dollar basis.

Below is a list of those transactions that are -- and are not -- inclusion events:

Inclusion Events

- A sale of an direct interest in a QOF. In addition, it appears that Prop. Reg. Section 1.1400Z2(b)-1(c)(6) and (6)(v) also create an inclusion event if a partner sells an interest in a partnership that in turn has an interest in a QOF. For example, if A owns a 1/3 interest in partnership ABC, which in turns own an interest in a QOF, if A sells her interest in ABC, it would trigger a portion of ABC's deferred gain. A similar, but more forgiving, rule exists for an S corporation that invests in a QOF: in this case, if the S corporation experiences an aggregate change of more than 25% of its ownership, ALL of the gain deferred by the S corporation must be recognized. Smaller changes of ownership in an S corporation that invests in a QOF, however, will not trigger deferred gain of the S corporation.

- Termination or liquidation of the QOF,
- Liquidation of a corporate owner of a QOF (to the extent Section 336 treats the QOF investment as having been "sold" in the liquidation),
- Transfer of a QOF investment by gift,
- A conversion of an S corporation investor in a QOF to a partnership or disregarded entity.
- A redemption of an eligible interest by a QOF C corporation unless the redeemed shareholder was the sole shareholder.

Non-Inclusion Events

- Liquidation of a corporate owner of a QOF if the liquidation is into a parent who owns 80% of the taxpayer, making the liquidation tax-free under Sections 332 and 337,
- Generally, transfer of an investment in a QOF at death,
- Contribution of a QOF interest to a grantor trust, provided the taxpayer is the deemed owner of the trust.
- Transfer of a QOF interest to a partnership in exchange for a partnership interest under Section 721,
- The making or revocation of an S election,
- Qualifying Section 381 transactions resulting from tax-free reorganizations.

Once an inclusion event has been identified, the next step is to determine the amount of the inclusion. For most transactions, it is dependent on the portion of the QOF investment sold or exchanged. As a general rule, when the QOF IS A C CORPORATION the amount of deferred gain recognized is equal to the EXCESS OF:

- the lesser of:
  - the fair market value of the disposed interest/the fair market value of the total qualifying investment * the remaining deferred gain, or
  - the fair market value of the disposed interest.
- OVER the taxpayer's basis in the portion of the investment sold (this will be zero until at least year 5, or unless a previous inclusion event occurred).

When the QOF is a *partnership or S corporation, however*, the rule is slightly different. In this case, the amount of deferred gain that is triggered upon an inclusion event is the LESSER OF:

- the percentage of the investment sold * the remaining deferred gain (counting any basis adjustments at the 5 or 7 year mark), or
- the gain that would have been recognized on a fully taxable sale of that portion of the investment in the QOF that was disposed of in the inclusion event.

Ex. In October 2018, A and B each realize $200 of eligible gain, and C realizes $600 of eligible gain. On January 1, 2019, A, B, and C form Q, a QOF partnership. A contributes $200 of cash, B contributes $200 of cash, and C contributes $600 of cash to Q in exchange for qualifying QOF partnership interests in Q. A, B, and C hold 20%, 20%, and 60% interests in Q, respectively.

On January 30, 2019, Q obtains a nonrecourse loan from a bank for $1,000. Under section 752, the loan is allocated $200 to A, $200 to B, and $600 to C. On February 1, 2019, Q purchases QOZBP for $2,000. On July 31, 2024 -- after the 5-year anniversary had been reached and each of A, B, and C have increased their basis (and reduced their deferred gain) by 10% -- A sells 50% of its qualifying QOF partnership interest in Q to B for $400 cash. Prior to the sale, there were no inclusion events.

Because A held its qualifying QOF partnership interest for at least five years, A's basis in its partnership interest at the time of the sale is $220 (the original zero basis with respect to the contribution, plus the $200 debt allocation, plus the 10% increase of his original $200 of deferred gain for interests held for five years). The sale of 50% of A's qualifying QOF partnership interest to B requires A to recognize $90 of eligible gain, the lesser of

- *50% of the remaining $180 deferred gain ($90), or*
- *the gain that would be recognized on a taxable sale of 50% of the interest ($400 cash + $100 debt relief - $110 basis), or $390.*

When certain inclusion events occur -- mainly, distributions that exceed an owner's basis in the investment -- deferred gain is recognized dollar-for-dollar by the amount of gain recognized on the distribution.

Ex. On January 1, 2019, A and B form Q, a QOF partnership, each contributing $200 that is deferred under the section 1400Z-2(a) election to Q in exchange for a qualifying investment. On November 18, 2022, Q obtains a nonrecourse loan from a bank for $300. Under section 752, the loan is allocated entirely to B. On November 30, 2024 -- a period of time after the 5-year holding period has been met and A has increased his basis from $0 to $20 -- Q distributes $50 to A.

A is required to recognize $30 of deferred gain because the $50 distributed to A exceeds A's $20 basis in its qualifying investment (the original zero basis with respect to its contribution, plus $20 created after the 5-year holding period was met).

All investments of deferred gain into a QOF start with a basis of zero, before being increased at the five (10%) or seven-year (5%) anniversaries. In addition, if an investor in a QOF recognizes an inclusion event, the new proposed regulations permit the investor to increase his or her basis in the QOF by the amount of deferred gain recognized as a result of the inclusion event. Importantly, Prop. Reg. Section 1.1400Z2(b)-1(g) provides that the basis increase is taken into account immediately BEFORE determining the tax consequences of the inclusion event. This prevents a double recognition of gain.

Ex. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to Q, a newly formed QOF corporation, in exchange for all of the outstanding Q common stock and elects to defer the recognition of $500 of capital gain. In 2020, when Q has $40 of earnings and profits, Q distributes $100 to A (the Distribution).

The Distribution is first evaluated without regard to any basis adjustment resulting from the inclusion event. Of the $100 distribution, $40 is treated as a dividend under Section 301(c)(1), and because A has a zero basis in the Q stock under the normal QOF rules, $60 is treated as gain from the sale or exchange of property under Section 301(c)(3). As a result, A recognizes $60 of the deferred gain.

Next, A is treated as having increased his basis in the Q stock by $60 BEFORE determining the tax consequences of the same distribution that caused the inclusion event. This gives A a $60 basis in the Q stock, which means the $60 distribution in excess of the $40 of E&P is now a tax-free return of A's basis. When all is said and done, A has recognized $60 of the previously deferred gain, no gain on the current distribution of $100 (other than the $40 dividend) and has a basis in the Q stock of $0 ($60 increase less $60 distribution).

Question #7: Does an investor have to sell the equity interest in a QOF after ten years, or can the QOF sell its assets with the gain still being tax-free to the investor?

Q: The real carrot being dangled by Section 1400Z-2 comes after an investor holds an interest in a QOF for ten years. After that holding period has been reached, the taxpayer may exclude the gain from the sale of an investment in a QOF that is attributable to an investment of previously deferred gain. The use of the word "investment" in the original proposed regulations implied that to benefit from the exclusion, a taxpayer must sell the equity interest in the QOF. Presumably, if the QOF were instead to sell its assets, any gain realized inside the QOF would be recognized.

A: The newest proposed regulations provide (partial) relief from a forced equity sale. The regulations provide that if a QOF formed as a partnership or S corporation sells its *assets*, a partner or shareholder who has held an interest in the QOF may elect to exclude any *capital gain* allocated to the partner or shareholder on Schedule K-1 resulting from the sale of QOZBP. Note, it does not require that the QOF generate the capital gain directly, but rather that it must *pass through* capital gain to the owners of the QOF. Presumably, this protects a QOF that operates through a subsidiary partnership, with that subsidiary partnership selling its assets after year 10 and passing capital gain to the QOF, which in turn passes capital gain to the partners or shareholders on Schedule K-1.

There is a quirk, however. If a partner or shareholder sells his or her *interest* in the QOF after 10 years, all of the gain may be excluded from income. If instead, however, the QOF sells its *assets*, only *capital gain* generated from the sale of QOZBP that is allocated to a partner or shareholder may be excluded. Thus, if the partnership or S corporation sells inventory, cash basis receivables, or assets subject to ordinary income depreciation recapture, a sale of the assets by the QOF after ten years will result in some degree of ordinary income recognition to the investors. Likewise, if the QOF were to sell non-QOZBP assets, any gain would be required to be recognized by the investors.

Also note, there is no protection for an asset sale made by a QOF that is a C corporation.

Question #8: What happens to an investor if a QOF sells some of its QOZBP during the ten-year holding period?

Q: A QOF may not wish to hold its QOZBP for the full ten years. The initial proposed regulations stated that future regulations would provide a QOF a "reasonable amount of time" to reinvest the proceeds from a sale, but provided no additional clarity.

A: The newest proposed regulations offer additional detail. A QOF will have 12 months to reinvest the proceeds from a sale of QOZBP, and as long as the proceeds are held in cash, cash equivalents, or debt instruments with a life of 18 months or less until they are reinvested, the proceeds will count towards the 90% test. But there's a catch: while the QOF's sale of assets won't trigger the deferred gain of any investor, any gain recognized by the QOF on the sale of its assets WILL be fully taxable. Thus, if the QOF is a partnership or S corporation, the gain will be allocated to the partners and shareholders and fully recognized.

Question #9: How does an operating business pass the "more than 50% test?"

Q: The original proposed regulations provided taxpayers enough guidance to move forward with constructing or improving real estate in a QOZ. The 30- month substantial-improvement rule, the 31-month working-capital safe harbor, and the 70% and 90% asset tests combined to provide a framework within which a QOF or subsidiary business could enter into a construction or rehabilitation project with a degree of certainty as to how those projects will comply with the requirements of Sec. 1400Z-2.

What remained far less clear, however, is how a QOF or subsidiary could invest in an operating business. The root of the problem was the requirement that to meet the definition of a QOZB, at least 50% of the income of a business would be required to be earned in a QOZ in each year. But how was this requirement measured when customers reside both within and outside the QOZ? Did the original regulations contemplate that more than 50% of the store's customers must reside within the QOZ? Or would the test be satisfied if the store is located within the QOZ, regardless of where the customers reside?

A: Last week's regulations put an end to the confusion. They provide three safe harbors and a facts and circumstances test that will enable a QOZB to satisfy the 50% test.

1. If at least 50% of the hours spent by employees and independent contractors are within the QOZ, the test is satisfied. Thus, if a company's employees are all located in a QOZ, it doesn't matter where the customers are located, the business will meet the test.
2. If at least 50% of the amount paid paid by a business to employees and independent contractors are for services performed within a QOZ, the test is satisfied. Thus, a taxpayer can have employees outside the QOZ, provided at least half of the total compensation is paid to employees performing services within the QOZ.
3. If the tangible property located in a QOZ and the management or operational functions performed in the QOZ are each necessary for the generation of at least 50% of the gross income of the business, the test is met.

It's also important to note that the latest regulations expanded the 31-month working capital safe harbor, which previously bought a QOZB time to convert cash into real property without violating the 70% test. Now, that same 31-month safe harbor can be used for the "development of a trade or business."

Question 10: How does the "original use" test work if you purchase a yet-to-be completed building or a building that has been vacant for years?

Q: To qualify as QOZBP, in general, property must either satisfy the "original use" test -- meaning the property had never before been used in the QOZ -- or be "substantially improved," with the taxpayer spending as much to improve the property over a 30-month period as was spent to acquire the property. But what if a taxpayer buys a building that is 97% complete, puts on the finishing touches, and places it into service for the first time? Is the original use test met? Or what if a taxpayer buys a building that has sat empty for several years? If the taxpayer gets it up and running -- but doesn't "substantially improve" it -- would that satisfy the original use test?

A: The newly issued proposed regulations provide that the "original use" of tangible property begins when any person first places the property in service for purposes of depreciation, or if they *could* have depreciated the property had they been the owner for tax purposes.

Thus, a QOF could purchase a partially finished business, complete construction and place it in service for depreciation, and the building will satisfy the original use test because it has never before been depreciated within the QOZ. In addition, if property has been vacant for five years, the "original use" period starts fresh, and the next taxpayer to place the property in service for depreciation purposes will satisfy the original use test.

In addition to the big ten questions addressed above, the new proposed regulations contained a few surprises. Let's take a look at those as well.

Contributions of property other than cash to a QOF

The statute and initial round of proposed regulations appeared to presume that a taxpayer wishing to defer eligible gain was required to contribute cash to a QOF. The newest round of regulations, however, make clear that a taxpayer can instead contribute property (but not services!) to the QOF in exchange for an interest. The regulations provide detailed rules on how to determine the amount of the investment resulting from such a contribution.

The ability to transfer non-cash property to a QOF would allow a taxpayer to take more "cash off the table" in a sale. For example, if A sells a building with a basis of $1 million for $1.8 million, A could pocket the entire $1.8 million, and instead contribute ANOTHER building that A owns with a basis of $800,000 (the amount of the gain on the sale) to a QOF, and the gain would be deferred. Of course, the building would not qualify as QOZBP to the QOF, because it had not been acquired "via purchase" by the QOF if the property were transferred in a tax-free Section 351 (to a QOF corporation) or 721 (to a QOF partnership) transaction. It is important to note that while for regular tax purposes, a contributing taxpayer in a tax-free transfer of this nature would have a "tacked" holding period in the equity interest received in exchange for the property, that is not the case here. The transferor's holding period begins on the date of the transfer, so as to not expedite the 5, 7 and 10-year holding period markers.

If the property were transferred to the QOF in a fully taxable transaction in which the QOF is treated as purchasing the property (for example, a transfer to a QOF corporation that does not meet the standards of Section 351), presumably the property would qualify as QOZBP to the QOF, provided the "original use" or "substantial improvement" tests were met. Note, however, that Prop. Reg. Section 1.1400Z2(a)-1(b)(2)(vi) provides that any gain recognized by the transferor when contributing property to a QOF in a taxable transaction is not, in turn, eligible gain that may be deferred by making a SECOND contribution to the QOF.

Finally, the new proposed regulations clarify that a taxpayer can make an investment into a QOF by acquiring an existing partner or shareholder's interest in the QOF.

Relief from the 90% test for a QOF

The regulations provide that a QOF, when measuring it's compliance with the 90% test, may choose to exclude from both the numerator and denominator of its assets the amount of any property received by the QOF as a contribution in exchange for a membership interest in the QOF during the six month period prior to the test, as long as during the period after the contribution and before the testing date, the contribution was continuously held in cash, cash equivalents, or debt instruments with a life of 18 months or less.

This means that a QOF that continuously receives contributions of cash from investors need not worry that a significant contribution shortly before a six-month testing date will jeopardize the QOF's compliance with the 90% test.

Measurement of substantial improvement

The latest regulations continue to insist that a QOF or QOZB that acquires property that does not satisfy the original use test must substantially improve each separate asset that does not pass the test. This will create an administrative burden for those QOFs or QOZBs that acquire large groups of non-qualifying assets together, as the improvement will need to be measured separately and compared to the original cost of each asset. The latest proposed regulations did, however, contemplate a scenario where the IRS would consider comments recommending increased flexibility in this regard; either by allowing the QOF to aggregate certain assets together for purposes of measuring substantial improvement or allowing a QOF to to purchase property that satisfies the original use test with a value equal to the nonqualifying property in order to satisfy the substantial improvement test.

Disparate treatment still exists for QOFs and QOZBs. But why?

The statutory and regulatory language uses the term "qualified opportunity zone business" only in connection with a business being conducted *through a subsidiary* of a QOF. Whether intentional or not, this application of the QOZB requirement only to a subsidiary of a QOF results in vastly different consequences when a QOF operates a business directly, as compared with through a subsidiary. For example:

- A QOF that operates a business directly is required to hold 90% of its assets as QOZBP. If, however, the same QOF were instead to operate a business through a subsidiary, for the subsidiary to meet the definition of a QOZB, the subsidiary would be required to hold only 70% of its assets as QOZBP.
- Only a QOZB is subject to the rules of Sec. 1397C. This creates several important distinctions. For example, only a business conducted by a subsidiary would be required to generate 50% of its income from an active conduct of a trade or business in a QOZ. In addition, the 31-month working-capital safe harbor applies only to a QOZB. As a result, from a practical perspective, it would be virtually impossible for a QOF to directly undertake a large construction project without running afoul of the 90% test, because the QOF's cash would not qualify for the working-capital exception throughout the 31-month period.
- A QOZB may not be a "sin business" as defined under Sec. 144. There is no prohibition on a QOF's directly conducting a sin business, however.

It is possible that these differences are simply the result of poorly constructed statutory and regulatory language, but at least in the case of the 70% test (QOZB) versus the 90% (QOF) test, the preamble to the proposed regulations appears to have anticipated that result. There are no policy reasons why such important distinctions should exist between operating a business directly in a QOF versus through a subsidiary,s the differences remain a mystery.

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