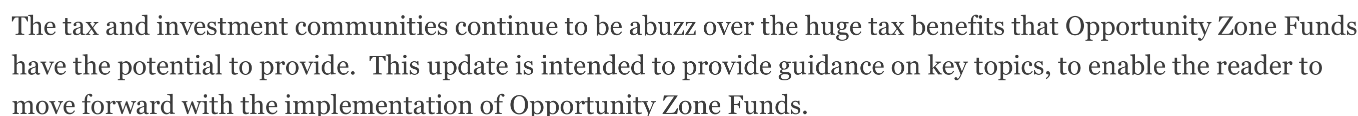
VENABLE LLP



The tax and investment communities continue to be abuzz over the huge tax benefits that Opportunity Zone Funds have the potential to provide. This update is intended to provide guidance on key topics, to enable the reader to move forward with the implementation of Opportunity Zone Funds.

*What is the Opportunity Zone program?*

The Tax Cuts and Jobs Act, signed into law on December 22, 2017, authorized a new tax incentive program to encourage investment in low-income community businesses.

*What are the benefits to investors?*

Under the Opportunity Zone program, individual and corporate taxpayers are eligible to defer paying tax on gains from the sale of stock, business assets, or any other property by investing the proceeds into an Opportunity Zone Fund (**QOF**). The QOF, in turn, must invest at least 90% of its assets, directly or indirectly, in businesses located in certain low-income communities designated as Qualified Opportunity Zones. Partial elimination of tax on deferred gains from that original, rolled-over investment results from a 10% increase in the basis of a QOF investment held for at least five years (such that investment in the QOF must occur by the end of 2021) and a 15% increase in the basis of a QOF investment held for at least seven years (such that investment in the QOF must have occurred by the end of 2019). All of the deferred gain will be realized at the end of 2026, if not realized by disinvestment sooner, including the occurrence of an "inclusion event" as discussed below. But the big prize is that future appreciation on the new investment in the Qualified Opportunity Zone can be excluded from taxation if the investment in the QOF is held for at least 10 years.

*What "gains" are eligible for investment under the Opportunity Zone program?*

Only capital gains are eligible for investment. This includes the gross amount of any Section 1231 capital gains (determined without regard to any Section 1231 losses) and certain capital gain dividends from real estate investment trusts (**REITs**) and regulated investment companies (**RICs**). Any gain treated as ordinary income (including capital gain that is recharacterized as ordinary income) is ineligible.

*Are capital gains realized by a partnership, corporation, REIT, or other entities eligible?*

Yes. Gains recognized by individuals, C corporations, S corporations, RICs, REITs, partnerships, and certain other pass-through entities are all eligible.

*Who can/must be the investor in the QOF?*

Where an individual or C corporation sells property at a gain, such individual or C corporation must be the person that makes the investment in the QOF. Although the investor generally must be a U.S. resident for tax purposes, nonresident alien individuals and foreign corporations may make the investment with capital gains that are "effectively connected" to a U.S. trade or business. See the following Q&A regarding a partnership or S corporation realizing capital gain.

*If the capital gain is realized by a partnership or similar pass-through entity, is it the entity or the owner that must reinvest the gain to qualify?*

The partnership may elect to defer the gain. If the partnership does not elect to defer the gain, then a partner may elect to defer its portion of the partnership's gain. The same rule generally applies to other pass-through entities (including S corporations, decedents' estates, and non-grantor trusts) and to their shareholders and beneficiaries.

*Are capital gains realized from sales to persons related to or affiliated with the seller eligible?*

No. Gains that arise from a sale or exchange with a related person are not eligible. "Related person" is defined for this purpose using a 20% common ownership test.

*By what date must gain be realized in order to be eligible?*

The taxpayer must realize the gain no later than December 31, 2026, in order to obtain any deferral (all deferral ends as of December 31, 2026 in any event) and exclusion benefits from the Opportunity Zone program.

*By what date must gain be invested in order to be eligible?*

Generally, a taxpayer must invest eligible gain in a QOF within 180 days of the sale or exchange in order to qualify for the benefits of the Opportunity Zone program. Special periods apply to certain types of gains, as outlined below:

| Type of Investor | Type of Gain | Rollover Period |
|---|---|---|
| All | Capital Gain | 180 days from the date of the sale or exchange generating the gain |
| All | Eligible Section 1231 Gain | 180 days from the date of the sale or exchange generating the gain |
| RIC/REIT Shareholder | RIC/REIT Distributed Capital Gain Dividends | Either: (i) 180 days from the close of the shareholder's tax year in which the gain would have been recognized absent the QOF investment; or (ii) 180 days from the date the dividend is paid |
| RIC/REIT Shareholder | RIC/REIT Undistributed Capital Gain Dividends | Either: (i) 180 days from the close of the shareholder's tax year in which the gain would have been recognized absent the QOF investment; or (ii) 180 days from the close of the RIC's or REIT's taxable year |
| Seller in an Installment Sale | Installment Sale Gain | Either: (i) 180 days from the date an installment sale payment is received; or (ii) 180 days from the last day of the tax year in which the installment sale gain would have been recognized absent the QOF investment (with a separate 180-day period applicable for each year in which installment payments are received) |
| Partner, S Corporation Shareholder, or Beneficiary of an Estate or Non-Grantor Trust | Eligible Gain from a Partnership, S Corporation, Estate, or Non-Grantor Trust if not reinvested by the entity or trust | Either: (i) 180 days from the date of the sale or exchange generating the gain; (ii) 180 days from the close of the entity's tax year in which the gain would have been recognized absent the QOF investment; or (iii) 180 days from the due date (not including extensions) of the entity's tax return for the year in which the gain would have been recognized absent the QOF investment |

The above chart sets forth the time period in which a taxpayer must invest in a QOF to qualify for the benefits of the Opportunity Zone program. In addition, some benefits are available only to taxpayers who invest in a QOF before 2019 or 2021. Specifically, to qualify for the 15% basis step-up with respect to rolled-over gain, the taxpayer must have invested in the QOF by 12/31/2019. To qualify for the 10% basis step-up with respect to rolled-over gain, the taxpayer must invest in the QOF by 12/31/2021. Last, to qualify for any of the benefits of the Opportunity Zone program, the taxpayer must invest in the QOF by 12/31/2026.

*Can the investment in the QOF be in the form of equity?*

Yes. The investment must be in the form of an equity investment. Eligible equity interests include preferred stock and partnership interests with special allocations. However, if there is a deemed contribution of money to a QOF under the tax rules regarding partnership debt and its effect on basis, an increase in a partner's share of partnership liabilities as a result of such deemed contribution would not cause that basis increase to be an ineligible investment in the QOF.

*Can the investment be in the form of a loan to the QOF?*

No. The investment must be an equity investment. However, the taxpayer may use the equity interest in a QOF as collateral to secure a loan without affecting the status of the equity as an eligible investment. A taxpayer also may invest proceeds from a loan, provided the taxpayer has eligible gain to invest. There is no tracing of proceeds from the realization of capital gain to the reinvestment in a QOF.

*Can the investment be initially in the form of a loan to the QOF and later convert to an equity interest?*

It is unclear at this time. The preamble to the Regulations includes a fact pattern where the taxpayer loans money to a QOF, the taxpayer subsequently realizes eligible gain, and the taxpayer then transfers its creditor position in the loan to the QOF, intending such transfer to be a rollover of eligible gain. The IRS declined to advise on whether this structure would result in a qualifying investment, noting that "[d]etermination of the tax treatment of the arrangement described previously would require a debt-equity analysis based on a careful examination of all relevant facts and circumstances and Federal income tax principles apart from those found in section 1400Z-2 and these regulations."

*Can the investment in the QOF be made with property other than cash?*

Yes. If a taxpayer transfers property other than cash to a QOF, the taxpayer's QOF investment (i.e., the portion of the taxpayer's investment that is eligible for Opportunity Zone program benefits) is equal to the lesser of (1) the taxpayer's basis in the transferred property or (2) the fair market value of the taxpayer's QOF investment (in the case of a QOF that is a partnership, determined without regard to any liabilities allocated to the taxpayer).

Note that QOF equity interests issued solely in exchange for the taxpayer's services (i.e., a carried interest) would not be qualifying QOF investments eligible for the Opportunity Zone program benefits.

*Can an interest in a QOF be acquired from a person other than the QOF?*

Yes. An investor can invest capital gain in a QOF by buying an interest in the QOF from another person. The transferor is not required to have made a prior deferral election for the acquirer to make such an election. The purchase can be made using either cash or property. The qualifying investment in the QOF is either (i) the amount of cash paid for the QOF interest or (ii) the fair market value of property other than cash. Note that if the investor transfers appreciated property and triggers taxable gain on the purchase, that gain is not eligible for deferral via investment in a QOF.

*Can the taxpayer invest more than his or her deferred gain in a QOF?*

Yes; however, such investment would be treated as a "mixed-funds" investment.  A taxpayer has a "mixed-funds" investment if:

- The taxpayer contributes cash or other property to the QOF that is greater than the taxpayer's eligible gain.  In this case, the QOF investment would be limited to the taxpayer's eligible gain.  Any equity received for the excess amount contributed would not be eligible for the Opportunity Zone program benefits.
- The taxpayer contributes property that has a fair market value in excess of the property's adjusted basis in a nonrecognition transaction.  Here, any equity received for the excess amount would not be eligible for the Opportunity Zone program benefits.
- The taxpayer receives part of his or her QOF equity in exchange for services rendered (i.e., a carried interest).  Here, the portion of the equity that would not be eligible for the benefits of the Opportunity Zone program is equal to the taxpayer's share of residual profits attributable to the "service" portion of the interest.

If a taxpayer has a mixed-funds investment in a QOF (including a QOF taxed as a partnership), the taxpayer would be treated as having two separate interests solely for purposes of the Opportunity Zone program.  If the QOF is a flow-through entity, items of income, gain, loss, and deduction would be allocated to the interests based on the taxpayer's relative capital contributions for each "separate" interest.

*Can the taxpayer sell property to an unrelated QOF and invest gain from such sale into the same QOF?*

No.  In the Regulations the IRS advises that a sale to a QOF (even if the seller is and remains unrelated to the QOF) followed by a subsequent investment of the resulting gain by that seller into the QOF will be recharacterized as a contribution of the property to the QOF by the taxpayer in exchange for an interest in the QOF.  And as a result, the contribution will not qualify for the Opportunity Zone program.  Similarly, when a taxpayer sells a property to an unrelated QOZB and invests the gain from such sale back into the QOF that owns such QOZB all as part of a plan, the initial sale transaction would not result in eligible gain for the taxpayer.  Note also that because QOZBP must be acquired from an unrelated party, any property acquired by a QOF or a QOZB in such manner would not qualify as QOZBP.

*Where are Opportunity Zones located?*

Each state, DC, and certain territories were required to nominate Qualified Opportunity Zones within their jurisdictions for certification by the Treasury Department.  That process is complete.  A list and maps of Opportunity Zones are available at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

*What requirements apply to setting up a QOF?*

A partnership or corporation certifies itself as a QOF by filing an election with its tax return for the first year during which the entity desires to be a QOF.  The election is made on Form 8996, Qualified Opportunity Fund.  The form requires a QOF to provide the IRS with information regarding the value of the QOF's assets and qualified opportunity zone property.

Note that no approval or action by the IRS or other federal agency is needed for certification. The statutory requirements are limited to the following:

(i) The QOF must be organized as a corporation or partnership; and

(ii) The QOF must be organized for the purpose of investing in "qualified opportunity zone property."

The requirement that the QOF be a corporation or partnership refers to the QOF's characterization for federal income tax purposes. Thus, a state law limited liability company with more than one member (and that has not made an election to be treated as an association taxable as a corporation) would be treated as a partnership and is eligible to self-certify as a QOF.

No restrictions apply as to who may organize, own, or manage a QOF. Thus, QOFs can be single-investor funds in which a single taxpayer with gains to defer forms its own fund and directly controls the timing and selection of its investment in Opportunity Zone Property. Note that in order to have only a single investor/owner, an QOF would need to be classified as a corporation for federal income tax purposes, and corporate income tax status may not be the best way to achieve all of a QOF's tax objectives (e.g., any losses would not pass through to the investor). At the other end of the spectrum, a sponsor could raise funds from multiple taxpayers who have recognized gains and pool their gain rollovers into a multi-investor QOF, with the sponsor selecting and managing the QOF's investments.

*Are there ongoing compliance filings that a QOF must make each year?*

Yes. Form 8996 must be filed annually by the QOF. More importantly, as discussed below, a QOF must hold at least 90% of its assets in Opportunity Zone Property. This testing requirement comes with its own, separate monetary penalty for non-compliance. The monetary penalty is calculated, if applicable, on Form 8996.

*Are there ongoing compliance filings that an investor must make each year?*

An investor in a QOF must file Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, on an annual basis to inform the IRS of the QOF investments held at the beginning and end of the current tax year, as well as any capital gains deferred by investing in a QOF.

*What is the process for making the capital gain deferral election?*

Taxpayers will make the deferral election on Form 8949, Sales and Other Dispositions of Capital Assets, attached to taxpayers' income tax returns for the year in which the gain would have been recognized but for the deferral election.

*How quickly must a QOF invest in Opportunity Zone Property?*

At least 90% of the assets of a QOF must be invested in "**Opportunity Zone Property.**" Opportunity Zone Property includes both (i) direct ownership and operation by the QOF of Qualified Opportunity Zone Business Property and (ii) indirect investment in such business property via investments in equity interests in one or more operating subsidiary entities (which in turn must each be a tax law corporation or partnership) that are

Opportunity Zone Businesses. The QOF should use the asset values reported on its applicable financial statement for the taxable year to determine whether the QOF has satisfied this test. If the QOF does not have applicable financial statements, the QOF should use the unadjusted cost of its assets.

The QOF must satisfy the 90% test on both the last day of the first 6-month period of the taxable year of the QOF and the last day of the taxable year of the QOF. The Proposed Regulations allow a QOF to designate the first month it will be treated as a QOF; however, no deferral election can be made for investments to the QOF until the "first month" elected by the QOF. Thus, depending on when funds are contributed into a QOF, the QOF would have six months at the most to invest at least 90% of its assets into Opportunity Zone Property. For example, if the first month for the QOF was October 2018 and the QOF uses the calendar year as its taxable year, then it will have only one testing date for its first year of operation – December 31, 2018. However, if the QOF's first month is February 2018 and the QOF uses the calendar year as its taxable year, it will have two testing dates in its first year of operation – July 31, 2018 and December 31, 2018.

For purposes of the 90% test, a QOF can exclude any investments received in the 6 months preceding the testing date, provided that such investments are cash, cash equivalents, or short-term (18 months or less) debt instruments.

*What happens if a QOF sells property that it holds? Does it get any grace period before the sale proceeds count against it for purposes of the 90% test?*

A QOF is allowed 12 months from the date of the distribution, sale, or disposition of qualified opportunity zone stock, qualified opportunity zone partnership interests, or Qualified Opportunity Zone Business Property to reinvest proceeds from such transaction in other qualifying property. During such 12-month period, any proceeds must be held in cash, cash equivalents, or short-term (18 months or less) debt instruments.

The IRS specifically has declined to provide for a reinvestment grace period for proceeds from asset dispositions by QOZBs. Thus, following a disposition, any cash held by the QOZB likely will have adverse effects under the several tests that apply for determining QOZB status. Cash proceeds from an asset disposition may qualify for the Working Capital Safe Harbor if the regulatory requirements of such provision are satisfied.

Note, however, that if a QOF disposes of its assets, the QOF likely would recognize gain. If the QOF is a pass-through entity, this gain would flow through (i.e., be taxable to) its owners (except to the extent that the owners have satisfied the 10-year holding period requirement, discussed in more detail below). The result is that, for sales within the 10-year holding period, the investors will have flow-through gain even if the QOF reinvests 100% of the proceeds from any sale into qualifying property.

*If a QOF invests in a corporation or partnership in an Opportunity Zone, how quickly must that entity invest in Qualified Opportunity Zone Property?*

As noted above, a QOF can invest in qualifying projects directly (including through a single-member, disregarded limited liability company) or indirectly through a corporation or partnership. The time for a QOF to make its investment directly or into the stock or partnership interest of a subsidiary is discussed in the context of the 90%

test and its related penalty. The topic here is the time for a subsidiary corporation or subsidiary partnership of a QOF to invest funds received from its parent QOF.

A QOF's interests in a corporation or partnership qualify for the 90% asset test if the corporation or partnership qualifies as a QOZB. The corporation or partnership must be a QOZB both at the time the QOF acquires its interests in the subsidiary and during substantially all (i.e., 90%) of the QOF's holding period for its interests in the subsidiary.

Among the requirements for the subsidiary to qualify as a Qualified Opportunity Zone Business (**QOZB**) are that:

1. Substantially all (i.e., at least 70%) of the tangible property owned or leased by the subsidiary is Qualified Opportunity Zone Business Property (**QOZBP**), as determined by the following criteria:
    a. The property is acquired by the subsidiary by purchase after December 31, 2017;
    b. The original use of the property commences with the subsidiary or the subsidiary substantially improves the property (these requirements are discussed below); and
    c. During substantially all (i.e., at least 90%) of the subsidiary's holding period for the property, substantially all of the use of the property was in an Opportunity Zone.
2. The subsidiary derives at least 50% of its gross income from the active conduct of a trade or business in the Opportunity Zone;
3. The subsidiary has less than 5% of the average of the aggregate unadjusted basis of its property attributable to "Nonqualified Financial Property," and
4. The subsidiary uses a substantial portion (i.e., 40%) of any intangible property in the active conduct of a trade or business in the Opportunity Zone.

These rules come by cross-reference to other tax programs, which require that such tests be satisfied on a taxable-year basis. Accordingly, investing cash so as to satisfy these tests by the end of the first taxable year (which could be a short year) could be difficult or impossible for many QOZBs.

"Nonqualified Financial Property" is defined elsewhere in the Internal Revenue Code as debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other, similar property specified in regulations, but does not include (1) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or (2) certain debt instruments. Such term would include bank accounts, checking accounts, and other time and demand deposits.

Although not specifically listed, the term "Nonqualified Financial Property" also would include cash on hand. However, as discussed below, the IRS provided a "Working Capital Safe Harbor" in the Regulations that protects against a violation of the test for cash or other investments held in compliance with safe harbor requirements.

*What are the requirements for the Working Capital Safe Harbor? And what tests does it protect against failing?*

The safe harbor is available for businesses that acquire, construct, or rehabilitate tangible business property (including real property) and any entities that are developing a trade or business in the Opportunity Zone. Such businesses can hold cash for a period of up to 31 months if:

1. there is a written plan that identifies the cash as held for the acquisition, construction, or substantial improvement of opportunity zone property or the development of a trade or business in an Opportunity Zone;
2. there is a written schedule showing that the cash will be used within 31 months; and
3. the business substantially complies with the written schedule.

Furthermore, if a business is unable to complete its plan within 31 months because it is waiting for government action, this failure to comply would not be considered a violation of the safe harbor. An extra 24-month period is available for a QOZB if the QOZ is located in a federally declared disaster area and the project is delayed due to such disaster.

Satisfaction of the Working Capital Safe Harbor provides the following benefits to a QOZB:

1. Such amounts need not be taken into account for purposes of the limitation that no more than 5% of the assets can be Nonqualified Financial Property.
2. Earnings on such amounts count favorably for purposes of the 50% gross income test.
3. Such amounts are treated favorably for purposes of the 40% use of intangible property with the QOZ test.
4. Such amounts are not treated as causing a failure of the requirement that, if a QOZB holds tangible personal property, 70% of such tangible personal property be acquired, constructed, or substantially improved in the QOZ.

Note that the Working Capital Safe Harbor does not apply at the QOF level. Thus, the timing rules for expenditure of funds by the QOF are generally dictated by the desire to avoid imposition of the penalty applicable to failure to comply with the 90% expenditure test.

*Why are most Opportunity Zone investments structured using two tiers?*

Although a two-tiered structure is not required, most QOFs use a two-tiered structure for two major reasons. First, the two-tiered structure provides more flexibility with regard to the QOF asset test. As noted above, 90% of the QOF's assets must qualify as Opportunity Zone Property. However, at the QOZB level, only 70% of the QOZB's property must be QOZBP. If the QOZB satisfies this 70% test, then 100% of the value of the QOF's interest in the QOZB is treated as Opportunity Zone Property. The QOF can take advantage of this lower 70% test only through a QOZB, not directly. Second, the Working Capital Safe Harbor is available only at the QOZB level and not at the QOF level. Accordingly, using the two-tiered structure provides greater flexibility with regard to how much cash can be held by the business.

*How quickly must rehabilitation of acquired existing Opportunity Zone Property occur?*

Here again is one of numerous instances in which uncertainty exists in implementing the Opportunity Zone Program: Either a QOF or its subsidiary must substantially improve the property it acquires, unless the "original use" (as discussed below) of the property in the Opportunity Zone commenced with the QOF or subsidiary. To "substantially improve" a property, during a 30-month period a QOF (or its subsidiary) must make additions to its basis with respect to the property in the hands of the QOF (or subsidiary) that exceed its basis in the property at the beginning of the 30-month period. The rehabilitation must occur "during any 30-month period beginning after the date of acquisition of such property." Whether the substantial improvement test is satisfied generally is determined on an asset-by-asset basis. However, a business can include purchased original use assets for purposes of determining the amount spent to substantially improve property if the purchased original use assets (i) are used in the same trade or business in the QOZ for which the non-original use asset is used, and (ii) improve the functionality of the non-original use assets in the same QOZ. Certain buildings located on the same parcel(s) of land can also be aggregated and treated as a single item of property.

Although the statute appears to provide flexibility regarding when the 30-month period can be considered to begin, until the IRS provides guidance on the timing of commencement requirement, taxpayers may want to take a conservative approach and plan to complete required improvements of their property during the 30-month period beginning on the date of acquisition.

*What does it mean that the "original use" of Opportunity Zone Property must be by the QOF?*

For all projects, the "original use" of the property in the Opportunity Zone must commence with the QOF, or the QOF must substantially improve the property. The substantial improvement requirement is discussed in the Q&A immediately above. The original use standard has been used in other programs similar to the Opportunity Zone program (including the Gulf Opportunity Zone program and the DC Enterprise Zone program), which indicates that the standard's application to tangible personal property should be clear: new tangible personal property purchased by the QOF or a subsidiary that constitutes a QOZB and first used in an Opportunity Zone should qualify. Property that has been depreciated or amortized by a taxpayer other than the QOF or the QOZB would not satisfy the original use requirement.

The rules with respect to real property are less clear. An existing building located in an Opportunity Zone could not satisfy the original use test when purchased by a QOF, and thus would have to be substantially improved. However, a vacant existing building can satisfy the original use requirement if such building has been vacant for (i) at least 1 year if the vacancy started before the Opportunity Zone designation or (ii) at least 3 years if the vacancy started after such a designation. Both cases require the real estate to remain vacant through the date of acquisition of the property by a QOF or QOZB. A building is considered vacant if more than 80% of the property, measured by the area, is not currently being used.

*Can vacant land be Qualified Opportunity Zone Business Property?*

Vacant land located in an Opportunity Zone does not need to satisfy the original use test or the substantial improvement test. However, vacant land can be Qualified Opportunity Zone Business Property if it is used in a trade or business of a QOF or a QOZB. A trade or business does not include holding land for investment.

*Can real property satisfy the Qualified Opportunity Zone Business Property rules when it straddles an Opportunity Zone census tract? If it can, what test applies?*

Yes. If the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the zone, and the real property outside of the zone is contiguous to part or all of the real property located inside the zone, then all of the property would be deemed to be located within a qualified zone. Real property located within the qualified opportunity zone should be considered substantial if the unadjusted cost of the real property inside a qualified opportunity zone is greater than the unadjusted cost of real property outside of the qualified opportunity zone.

*Can existing property that is leased by a QOF or by a QOZB qualify as Qualified Opportunity Zone Business Property?*

Yes, provided that (i) the lease is entered into after December 31, 2017 and (ii) substantially all of the use of the leased tangible property occurs in the Opportunity Zone during substantially all of the period for which the QOZB leases the property, and (iii) the lease must be a "market rate lease." The evaluation of whether a lease is at market rate takes into account whether the terms of the lease reflect common, arm's-length market practice in the locale that includes the Opportunity Zone. A lease between unrelated parties is presumed to be a "market rate lease."

*Must leased property satisfy the requirements applicable to purchased tangible property that its "original use" be in the Opportunity Zone and that it be "substantially improved"?*

No. Unlike tangible property that is acquired by purchase, leased tangible property is not subject to either the original use requirement or the substantial improvement requirement. But see the discussion below regarding tangible personal property leased from a related person.

*Can existing property be leased from a related person (lessor and lessee are related to one another under the numerous related person rules) and still qualify as Qualified Opportunity Zone Business Property?*

Yes. Unlike tangible property that is acquired by purchase, leased tangible property can be leased from a lessor by a QOF or a QOZB as lessee that is a person related to the lessor, provided that the following requirements are met (in addition to the general requirements discussed above that are applicable to all leased property):

First, a QOF or a QOZB must not prepay rents on the lease for more than 12 months.

Second, if the lease includes tangible personal property, then the lessee must become the owner of tangible Qualified Opportunity Zone Business Property that has a value not less than the value of the leased personal property. Acquisition of this property must occur during a period that begins on the date that the lessee receives possession of the property under the lease and ends on the earlier of the last day of the lease or the end of the 30-month period beginning on the date that the lessee receives possession of the property under the lease. This rule applies only to tangible personal property, such as furniture and equipment, and not to real property.

Last, an anti-abuse rule requires that for leased real property (other than unimproved land), no plan, intent, or expectation can exist that the real property will be purchased by the QOF or the QOZB at less than fair market value, to be determined at the time of purchase and without regard to prior lease payments.

Although the related party lease rules provide greater flexibility for taxpayers, related taxpayers should consider the potential disadvantages of entering into a lease of QOZBP. These rules allow a taxpayer who currently owns property in an Opportunity Zone to lease the property to a related QOF or QOZB and avoid several of the restrictions that would apply to the same existing property if acquired by purchase. But before switching from a purchase to a lease mode of acquisition, the parties should consider the effect of the lease on the program benefits to be realized upon a future disposition of the project when gain on the disposition is expected to avoid federal income tax. At the time of disposition, the value of the project will be split between the interests of the landlord and the tenant, with the Opportunity Zone Program benefits attaching only to the tenant's leasehold interest. Depending on the terms of the lease, some portion of the project's value will be attached to the landlord's reversionary interest, and the appreciation in value of the project eligibly allocable to that interest will not be eligible for the income exclusion benefit. Thus, the benefit of using a related party to avoid the related party restrictions applicable to acquisitions by purchase will need to be balanced against the loss of the income exclusion benefit for the portion of any ultimate gain that will be allocable to the landlord's reversionary interest.

*How is QOZBP acquired by lease valued for purposes of the 90% and 70% tests?*

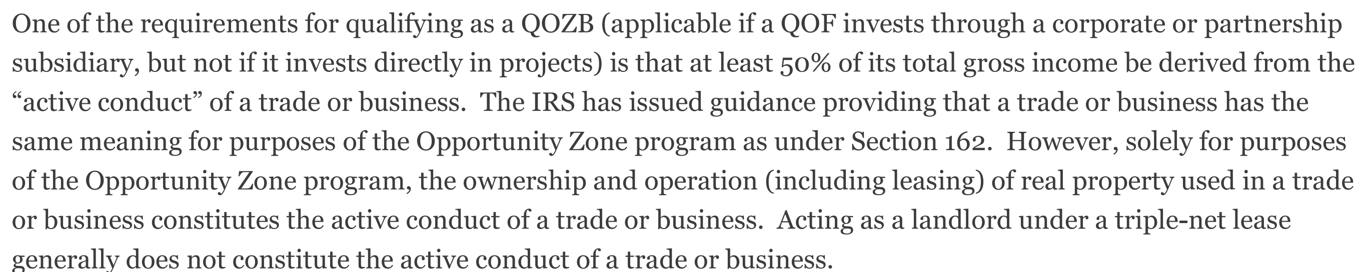
Valuation of the leased property is determined annually based on either (i) the reporting of the lease's value on the lessee's financial statements if those statements are prepared according to U.S. generally accepted accounting principles (GAAP) and require recognition of the lease of the tangible property or (ii) a present value calculation.

The IRS commentary notes that, beginning in 2019, generally accepted accounting principles (GAAP) require public companies to calculate the present value of lease payments in order to recognize the value of leased assets on the balance sheet.

The present value of the lease property is equal to the sum of the present values of the payments to be made under the lease for such tangible property, using the short-term "applicable Federal rate" set by Section 1274(d)(1) as the discount rate. The present-value valuation is made at the time the lease for such property is entered into. Once calculated, such calculated value is used as the value for such asset for all testing dates. The drawback to the discounted present value method (in contrast to the use of reporting on financial statements) is that it does not account for depreciation and thus will not adjust for changes in asset values over time.

*What types of projects/property are permissible investments?*

All types of projects and property qualify as permissible investments for a QOF, with the exception of the limited types of prohibited businesses if the investment is made through a subsidiary as follows: a 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 premises ("sin businesses"). A QOZB can lease up to 5% of its property to sin businesses. The prohibition on sin businesses does not apply to QOFs.



One of the requirements for qualifying as a QOZB (applicable if a QOF invests through a corporate or partnership subsidiary, but not if it invests directly in projects) is that at least 50% of its total gross income be derived from the "active conduct" of a trade or business. The IRS has issued guidance providing that a trade or business has the same meaning for purposes of the Opportunity Zone program as under Section 162. However, solely for purposes of the Opportunity Zone program, the ownership and operation (including leasing) of real property used in a trade or business constitutes the active conduct of a trade or business. Acting as a landlord under a triple-net lease generally does not constitute the active conduct of a trade or business.

*How does a QOZB determine if at least 50% of its total gross income is "from the active conduct of such business"?*

Three safe harbors and a facts and circumstances test are provided for determining whether sufficient income is derived from a trade or business in a qualified opportunity zone for purposes of the 50% test. Businesses only need to meet one of these safe harbors to satisfy that test.

The first safe harbor requires that at least 50 percent of the services performed (based on hours) for such business by its employees and independent contractors (and employees of independent contractors) are performed within the qualified opportunity zone. This test is intended to address businesses located in a qualified opportunity zone 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 qualified opportunity zone 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 during the taxable year.

The second safe harbor is based upon amounts paid by the trade or business for services performed in the qualified opportunity zone by employees and independent contractors (and employees of independent contractors). Under this test, if at least 50 percent of the services performed for the business by its employees and independent contractors (and employees of independent contractors) are performed in the qualified opportunity zone, based on amounts paid for the services performed, the business meets the 50 percent gross income test found in section 1397C(b)(2). This test is determined by a fraction, the numerator of which is the total amount paid by the entity for employee and independent contractor (and employees of independent contractors) services performed in a qualified opportunity zone during the taxable year, and the denominator of which is the total amount paid by the entity for employee and independent contractor (and employees of independent contractors) services performed during the taxable year.

The third safe harbor is a conjunctive test concerning tangible property and management or operational functions performed in a qualified opportunity zone, permitting a trade or business to use the totality of its situation to evaluate compliance with test. Thus, a trade or business may satisfy the 50 percent gross income requirement if (1) the tangible property of the business that is in a qualified opportunity zone and (2) the management or operational functions performed for the business in the qualified opportunity zone are each necessary to generate 50 percent of the gross income of the trade or business.

Finally, taxpayers not meeting any of these three safe harbor tests may meet the 50 percent requirement based on a facts and circumstances test if, based on all the facts and circumstances, at least 50 percent of the gross income of a trade or business is derived from the active conduct of a trade or business in the qualified opportunity zone.

*Can a QOF hold cash pending investment in Opportunity Zone Property?*

It depends – as discussed above, the Working Capital Safe Harbor is available to a subsidiary partnership or subsidiary corporation in which a QOF invests, but not to the QOF itself. Rather, the holding of cash by the QOF is restricted by the twice-annual application of the 90% test for investment by the QOF (and the resulting annual penalty for shortfalls in meeting the 90% tests) as discussed above.

*Putting all of the timing rules together, how long may funds invested into a QOF and by the QOF into a lower tier QOZB entity be held as cash?*

Stringing all the rules together can provide a period as long as 43 months for deployment of capital following investment of capital gain into a QOF under the following rules:

1. A QOF is subjected to the 90% test every six months but gets an exception for funds invested in the QOF with the prior six months. Thus, an investment early in a calendar tax year doesn't trigger a penalty until the December 31 testing date and thus permits almost 12 months before the QOF is compelled to invest in a lower-tier QOZB entity without penalty.
2. A lower-tier QOZB can make use of the 31-month Working Capital Safe Harbor to assist with its qualification as a QOZB while not having deployed the capital invested in it by the QOF.
3. Thus, on particular facts, the combination of the timing rules for application of the QOF 90% testing rules and the Working Capital Safe Harbor may provide nearly 43 months before all invested capital must be deployed.

*Can borrowed funds (leverage) be used in the Opportunity Zone program?*

Yes, leverage can be used at several different levels. Because there is no required connection between the capital gain that a taxpayer desires to defer and cash proceeds used to fund an investment in a QOF, a taxpayer could borrow such amounts. In addition, there is no prohibition on a QOF borrowing to partially fund (together with the taxpayer's equity investment in the QOF) the purchase of Opportunity Zone Property.

Similarly, a partnership or corporate subsidiary of a QOF could borrow to help fund a project. Borrowing at the subsidiary level could potentially be tailored to comply with the timing requirements and cash limitations discussed above – for example, a taxpayer's equity could be used to acquire an existing property, and then borrowed funds could be drawn down as needed to improve the property.

But if a QOF investor invests amounts in a QOF in addition to its capital gain eligible to be rolled into the QOF, then such excess investments will not be eligible for any of the benefits of the Opportunity Zone program, regardless of the source of the investor's fund for excess investment. Thus, an investor cannot take advantage of the exclusion benefit with respect to investments that it makes in a QOF in addition to its capital gain rollover.

*If land and a building are to be improved, how does the substantial improvement requirement apply to them?*

The QOF must substantially improve the building by spending an amount on improvements to the building at least equal to the QOF's cost basis in the building. The separate cost basis of the land does not affect the substantial improvement calculation for the building, and the land does not need to be improved in order for the substantial improvement requirement to be satisfied with respect to the overall project.

*When will the taxpayer's deferred gain be recognized?*

A taxpayer will recognize the deferred gain on the earlier of (1) an inclusion event; (2) the taxpayer's sale or exchange of the QOF investment; or (3) December 31, 2026.

If a taxpayer invests in a QOF and later sells or exchanges the QOF interest such that the taxpayer would recognize the deferred gain, then the taxpayer can reinvest the gain from the sale of the original QOF investment into another QOF and elect again to defer the previously deferred gain. This provision allows a taxpayer to make back-to-back investments. This provision is available even if the taxpayer has not disposed of its entire initial investment in the QOF. The reinvestment into another QOF would re-start the taxpayer's holding period for his or her QOF investment to the extent of the reinvested gain.

Although a taxpayer may be able to avoid recognition of the deferred gain by reinvesting his or her gain into a QOF, all deferred gain must be recognized by December 31, 2026, even if the taxpayer has not sold or exchanged his or her investment. Accordingly, taxpayers must be aware that they may have a gain recognition event in 2026 with no associated income or cash.

Note that a taxpayer may make separate investments in a QOF at different times. If the taxpayer fails to adequately identify the QOF stock sold, the IRS will identify the stock sold using the "first-in, first-out" method. Accordingly, taxpayers making multiple investments in the same QOF corporation are encouraged to separately identify these investments in the event of a future sale of less than all of a taxpayer's stock of the QOF. The separate identification rule does not apply to the disposition of interests in a QOF partnership.

*What is an "inclusion event"?*

An inclusion event is an event that results in the inclusion of deferred gain in gross income. Generally, the event is considered an inclusion event where (i) the event reduces an eligible taxpayer's direct equity interest in the qualifying investment; (ii) an eligible taxpayer receives a distribution with respect to the qualifying investment; (iii) an eligible taxpayer claims a loss for worthless stock; or (iv) a QOF in which an eligible taxpayer holds a qualifying investment loses its QOF status. The Regulations provide detailed rules as to a variety of events that will be considered to result in an inclusion event. Examples include the conversion of a QOF from a partnership to a corporation, de-certification of a QOF, and a transfer between spouses or incident to divorce. Gain arising from an inclusion event is eligible for deferral even though the taxpayer retains a portion of its qualifying investment after the inclusion event.

Qualifying investments that have been subject to inclusion events should continue to be eligible for an increase of basis if deferred gain has not yet been recognized at the time of this basis increase.

*What is the "exclusion benefit"?*

If a taxpayer holds an equity interest in a QOF for at least 10 years, the taxpayer generally is not subject to tax on gain attributable to the appreciation of his, her, or its QOF investment.

*How is the exclusion benefit realized?*

Sale of a QOF Interest: If a taxpayer holds an equity interest in a QOF for at least 10 years, the taxpayer can increase the basis of his or her equity interest to the fair market value of that equity interest on the date the interest is sold or exchanged. As a result, all of the gain attributable to appreciation in the QOF's value would be tax-free. The basis step-up is available only to the extent that the taxpayer elected to defer the recognition of capital gain. Accordingly, if a taxpayer invests cash (for which no deferral election has been made) and proceeds from a capital transaction (for which a deferral election has been made), the investment will need to be bifurcated, and the appreciation with respect to the cash portion will be subject to tax on the eventual sale or exchange of the QOF interest. The Regulations make it clear that on disposition of an equity interest in a QOF, all types of gain (including any "hot asset" gain or depreciation recapture that could exist if the QOF is a partnership) are excluded from the investor's income.

Sale of QOZBP or Opportunity Zone Property: If a taxpayer holds an equity interest in a QOF for at least 10 years, the taxpayer can elect to exclude from its gross income any gain recognized by the QOF as a result of the disposition by the QOF of its Opportunity Zone Property or any disposition by a subsidiary QOZBP of its property. Accordingly, if a QOF has a subsidiary partnership QOZB that sells an asset, the subsidiary partnership's gain (which ultimately would flow through to the investor) would be eligible for the exclusion. All types of gain (including distributions by a corporation to shareholders or by a partnership to a partner, any "hot asset" gain, or depreciation recapture that could exist if the QOF is a partnership) are excluded from the investor's income, except for gain attributable to sales of inventory in the ordinary course of business.

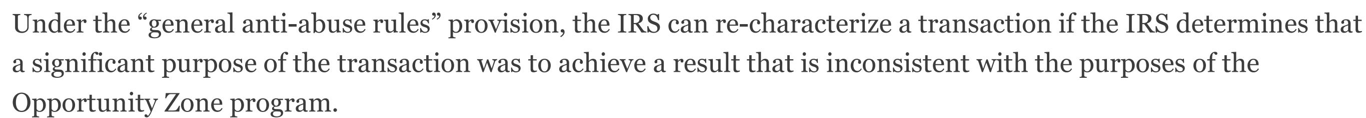
*What happens if an investor makes a gift of his or her QOF investment?*

A gift of a QOF investment is an "inclusion event." Accordingly, any gift to another person would result in the investor immediately recognizing his or her deferred gain. The recipient of the gift would have a new holding period in the QOF investment. A transfer to grantor trust generally is not considered to be transfer to a different taxpayer and thus will not trigger an inclusion event.

*What happens if an investor dies while holding a QOF investment?*

Death of an investor prior to December 31, 2026 does not trigger recognition of the deferred gain. Instead, the recipient of the QOF investment must recognize the deferred gain on the earlier of an inclusion event occurring to the recipient or December 31, 2026. While interests received due to death continue to be a qualifying investment in the hands of a transferee, the transferee is not allowed to adjust the basis of an inherited qualifying investment to its fair market value. The recipient of the QOF investment gets to "tack" the investor's holding period for purposes of determining whether the 5-, 7-, and 10-year holding requirements are satisfied.

*What is the "general anti-abuse rule"?*



Under the “general anti-abuse rules” provision, the IRS can re-characterize a transaction if the IRS determines that a significant purpose of the transaction was to achieve a result that is inconsistent with the purposes of the Opportunity Zone program.

*Is further guidance expected from the IRS to address questions that remain under the Regulations?*

The IRS has not indicated that it has any plans to provide further guidance on the Opportunity Zone program.