On April 17, the Treasury Department (Treasury) released the second set of proposed regulations concerning investing in qualified opportunity funds (QOFs) and qualified opportunity zones (QOZs) under Section 1400Z-2 of the Internal Revenue Code, which was added as part of the Tax Cuts and Jobs Act of 2017. Treasury released 169 pages of proposed regulations and explanations, answering a number of significant questions that had kept many taxpayers on the sidelines.

Background: Opportunity Funds and Opportunity Zones – Summary of Key Statutory Provisions

As enacted, Section 1400Z-2 permits taxpayers to defer recognition of gains if the gains are reinvested within 180 days into a qualified opportunity fund (QOF). The initial proposed regulations, released on Oct. 19, 2018, clarified that only capital gains are eligible for the tax benefits.

- The taxpayer generally must recognize the deferred gain on the earlier of (i) the date the investment in the QOF is sold or exchanged or (ii) Dec. 31, 2026.
- If the taxpayer holds its investment in a QOF for five or seven years, it may permanently exclude 10 percent or 15 percent, respectively, of the deferred gain.
- If the taxpayer holds its investment in a QOF for 10 years, the taxpayer can elect to step up the qualifying basis of such investment to fair market value, permanently excluding from gross income any appreciation in the value of that investment.
- The statute defines a QOF as a corporation or partnership organized for the purpose of investing in qualified opportunity zone property (QOZP) that holds at least 90 percent of its assets in QOZP, measured as of (i) the last day of the first six-month period of the taxable year of the QOF and (ii) the last day of the taxable year of the QOF.
- QOZP includes qualified opportunity zone stock, qualified opportunity zone partnership interests and qualified opportunity zone business property (QOZBP).
  - QOZBP is tangible property used in a trade or business of a QOF that is (i) acquired by purchase after Dec. 31, 2017, (ii) the original use of which begins with the QOF or the QOF substantially improves the property, and (iii) substantially all of the use of which is in a QOZ.
  - Qualified opportunity stock or partnership interests include stock or partnership interests acquired after Dec. 31, 2017, for cash, in a corporation or partnership that is a qualified opportunity zone business (QOZB) at the time the QOF acquires the stock or partnership interest (or, in the case of a new corporation or partnership, was being organized for purposes of being a QOZB) and throughout substantially all of the QOF’s holding period thereafter.
  - A QOZB is a trade or business with (i) substantially all of its tangible property, whether leased or owned, being QOZBP (substituting such business for QOF in the definition above); (ii) at least 50 percent of the gross income of which is derived from the active conduct of such trade or business; (iii) a substantial portion of the intangible property of which is used in such trade or business; (iv) less than 5 percent of whose assets (by aggregate basis) are attributable to nonqualified financial property; and (v) that does not operate a prohibited “sin business.”

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While the initial set of proposed regulations brought some much-needed guidance to the opportunity zone statutory provisions, they created new issues and left important questions unanswered. The 169-page second set of proposed regulations attempts to resolve a fair number of these issues, including the following:

- **QOFs, Investments in QOFs and QOF Interests**
  - **Acquisition of QOF Interests.** The proposed regulations clarify that a taxpayer may obtain the tax benefits of investing in a QOF by an investment of cash or property in the QOF or by acquiring a QOF interest from an existing investor. However, furnishing services in exchange for an interest in a QOF – e.g., a carried or profits interest – is not a qualifying investment eligible for the tax benefits of Section 1400Z-2.

    » In the case of acquiring a QOF interest from an existing investor, the taxpayer is treated as making an investment in a QOF in an amount equal to the amount invested or paid for the interest.

    » In the case of a contribution of property other than cash in a carryover basis transaction, the amount of the investment equals the lesser of (i) the taxpayer's adjusted basis in the equity received in the transaction or (ii) the fair market value of the equity received in the transaction.

    » In both cases, the amount treated as invested is limited to the amount of gain that may be deferred.

  - **Holding Period.** A taxpayer’s investment in a QOF generally begins on the date the QOF interest is acquired. Therefore, for purposes of the various timing rules involved, the period of ownership of a QOF interest does not include the holding period of the predecessor owner in the case of an acquisition of an interest in a QOF, nor does it include the holding period of property contributed to the QOF in exchange for the QOF interest.

  - **Treatment of Section 1231 Gains.** The only gain arising from Section 1231 property that is eligible for deferral under Section 1400Z-2 is a net capital gain determined by netting Section 1231 gains and losses for the taxable year. Therefore, the new proposed regulations provide that the 180-day period to invest capital gains with respect to Section 1231 property begins on the last day of the taxable year after such netting has occurred. (This is one aspect of the new proposed regulations that already has invited a good deal of questioning and commentary.)

  - **Inclusion Events.** As mentioned above, Section 1400Z-2 requires a taxpayer to recognize its deferred gain (or the fair market value of its QOF interest if less) over the adjusted basis of its QOF interest at such time on the earlier of Dec. 31, 2026, or the date its QOF interest is sold or exchanged.

    » However, the language in the relevant conference report used “disposed of or December 31, 2026.” To better track the conference report’s language, the new proposed regulations provide a nonexclusive list of events that would require the taxpayer to include all or a portion of its deferred gain in gross income, including most gifts of a QOF interest and some but not all nonrecognition transactions.

    » A transfer of a QOF interest at death or a contribution to a grantor trust or disregarded entity is generally not an inclusion event, and the transferee in such cases may tack the transferor’s holding period in the QOF interest.

  - **Basis Adjustments.**

    » **5 Percent and 10 Percent Basis Step-Up.** The proposed regulations clarify that the 5 percent and 10 percent basis step-ups are basis for all purposes so that, for example, losses suspended under Section 704(d) would be available to the extent of the basis step-up.

    » **10-Year Basis Step-Up.** After a taxpayer holds a QOF interest for 10 years, if the taxpayer sells or exchanges such interest, it may elect to have its basis stepped up to its fair market value. The new proposed regulations state that this basis adjustment is deemed to be made immediately prior to the sale or exchange, and, in the case of a QOF that is a partnership, it also results in an adjustment to the basis of the partnership’s underlying assets under principles similar to those in Section 743(b) of the code. The fair market value of a QOF partnership interest is determined by taking into account partnership debt.

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Special Income Exclusion Rules for QOFs Classified as Partnerships, S Corporations and Real Estate Investment Trusts (REITs).

» Partnership and S Corporations Income Exclusion. A taxpayer that holds a QOF partnership interest or QOF S corporation stock for at least 10 years may make an election to exclude from gross income some or all of the capital gain from the disposition by the QOF of directly owned QOZP reported on Schedule K-1 of such QOF.

- Based on the language of the new proposed regulations, this exclusion election is not similarly available for capital gain attributable to the sale of property by QOZBs, and as such, sales of assets by a QOZB at any time, including during a QOF’s winding down of operations, may result in taxable gain (even after a taxpayer has held its interest for 10 years).
- Additionally, if the sale of assets by a QOF or QOZB generates ordinary gain, such gain does not seem to be excludable under the new proposed regulations. (This should be contrasted to the sale after 10 years of an interest in a QOF in which all gain appears to be excluded.)

» REIT Income Exclusion. The proposed rules authorize QOFs that are organized as a REIT to designate special capital gain dividends not to exceed the QOF’s long-term gains on QOZP. Such special capital gain dividends are tax-free to shareholders who have held their QOF REIT shares for at least 10 years and could have elected a basis increase in case of a sale of the QOF REIT shares.

- The ability in certain circumstances to exclude capital gain from income is not available to a QOF organized as a C corporation that is not a REIT.

QOF Investment Grace Periods. The new proposed regulations provide two helpful grace periods for QOFs to comply with the 90 percent asset test.

» Newly Contributed Assets. A QOF can apply the 90 percent asset test without taking into account any investments received in the preceding six months as long as the new assets are held in cash, cash equivalents or debt instruments with a term of 18 months or less.

» Reinvestment Rule. Section 1400Z-2(e)(4)(B) authorizes regulations to ensure a QOF has “a reasonable period of time” to reinvest the return of capital from investments in QOZP. The new proposed regulations provide that proceeds received from the sale or disposition of QOZP are treated as QOZP for purposes of the 90 percent asset test if the QOF reinvests the proceeds within 12 months. If the failure to reinvest within 12 months is attributable to a delay in government action, the new proposed regulations extend the reinvestment period.

Consolidated Group Provisions.

» To avoid additional complexity and the creation of additional consolidated return rules, the new proposed regulations state that stock in a QOF classified as a corporation is not stock in a member of a consolidated group for purposes of the consolidated return regulations. Therefore, a QOF may be the common parent of a consolidated group but may not be a subsidiary member of a consolidated group.

- Additionally, Section 1400Z-2 applies separately to each member of a consolidated group – that is, the same member of the consolidated group must (i) sell a capital asset and (ii) reinvest the gain in a QOF.

Tangible Property Rules

- Leased Property. Under 1400Z-2, QOZBP must be acquired by “purchase,” but the substantially all test for QOZBs includes owned or leased QOZBP. The new proposed regulations provide that:

- Leased tangible property may be treated as QOZBP for purposes of satisfying both the 90 percent asset test for directly held QOZBP and the substantially all (clarified to mean 70 percent under the initial proposed regulations) requirement for QOZBs if (i) the leased tangible property was acquired under a lease entered into after Dec. 31, 2017, and (ii) substantially all of the use of the leased tangible property is in the QOZ for substantially all of the period for which the business leases such property.

- Notably, the requirements applicable to owned tangible property – that property be acquired from an unrelated party and have its original use in the QOZ or is substantially improved – do not apply to leased property.

- However, the proposed regulations require that in all cases, the lease under which a QOF or QOZB acquires rights to tangible property must be a “market rate lease” as determined by the principles under Section 482 of the code. If the lessor and lessee are related, the leased property must satisfy two additional requirements: (i) the QOF or QOZB cannot make a prepayment to the lessor relating to a period of use of the leased...
tangible property that exceeds 12 months, and (ii) if the original use of leased tangible personal property (as defined in the new proposed regulations) in a QOZ does not commence with the lessee, the lessee must become the owner of QOZBP that has a value not less than the value of the leased personal property.

The proposed regulations also include an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement when, at the time the lease is entered into, there was a plan, intent or expectation for the property to be purchased by a QOF for an amount other than the fair market value.

**Value of Lease.** The new proposed regulations address concerns regarding valuing a lease for purposes of the 90 percent and 70 percent tests and provide two methods for valuing leased tangible property for such purposes:

- Financial statement valuation method – whereby the value of leased tangible property is the value of that property as reported on the applicable financial statement for the relevant reporting period (only if the financial statement is prepared in accordance with generally accepted account principles).
- Alternative valuation method – whereby the value of leased tangible property is its present value, which is equal to the sum of the present values of the payments to be made under the lease.

**Original Use.** The initial proposed regulations reserved the meaning of “original use” with respect to tangible property. Under the new proposed regulations, original use of tangible property acquired by purchase commences when that person first places the property in service in the QOZ for purposes of depreciation and amortization.

**Vacant Buildings.** If property has been unused or vacant for an uninterrupted period of at least five years, the new proposed regulations provide that its previous history within the QOZ may be disregarded for purposes of the original use requirement.

**Substantial Improvement.**

- **Leased Property.** Improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property for the amount of the unadjusted cost basis of such improvements.

- **Land.** Under the new proposed regulations, land acquired after Dec. 31, 2017, can be a qualifying asset provided it is used in a trade or business.

To address potential speculative land purchasing issues, the new proposed regulations clarify terminology and include specific anti-abuse rules.

- Under Section 1400Z-2, QOZBP must be tangible property used in a trade or business. The new proposed regulations clarify that a trade or business means a trade or business within the meaning of Section 162 of the code and that holding land for investment is not a trade or business and such land cannot be QOZBP.

- Land also will not be QOZBP if it is unimproved or minimally improved and the QOF or QOZB purchases the land with an expectation, an intention or a view to not improve the land by more than an insubstantial amount within 30 months after the date of purchase.

Furthermore, if a significant purpose for acquiring unimproved land was to achieve an inappropriate tax result, a general anti-abuse rule (discussed below) would apply to treat such acquisition as an acquisition of nonqualifying property.

**Asset-by-Asset Test.** Under the new proposed regulations, the determination of whether tangible property is substantially improved occurs on an asset-by-asset basis.

- **Inventory in Transit.** Inventory of a QOF, including raw materials, does not fail to be used in a QOZ solely because inventory is in transit from a vendor to a facility of the trade or business that is in the QOZ or from a facility of the trade or business that is in a QOZ to customers of the trade or business that are not located in a QOZ.

**Definition of Substantially**

The term substantially all is used throughout Section 1400Z-2. The new proposed regulations provide definitions for substantially all where it had not already been defined:

- Substantially all means 70 percent for determining usage of QOZBP (whether owned or leased) in a QOZ.
- Substantially all means 90 percent when determining a QOF’s holding period of QOZP and a QOZB’s holding period of tangible property as QOZBP.

**QOZB Requirements**

- **Real Property Straddling a QOZ.** For purposes of determining whether real property of a QOZB that straddles census tracts is located within a QOZ, the new proposed regulations provide that if the amount of real property based on square footage located within the QOZ is substantial as compared to the amount of real property based on square footage outside the QOZ and the real property outside the
QOZ is contiguous to part or all of the real property located inside the QOZ, then all of the property would be deemed to be located within a QOZ.

- **50 Percent Gross Income.** A QOZB must derive 50 percent of its total gross income from the active conduct of a trade or business within a QOZ. Commentators expressed concern that this requirement would negatively affect companies that perform the majority of their services outside a QOZ or sell services or products over the internet. The new proposed regulations provide three safe harbor tests and a facts and circumstances test to determine whether the 50 percent requirement is met:
  - Based on hours, at least 50 percent of the services performed by the business’s employees and independent contractors (and employees of independent contractors) are performed in the QOZ.
  - Based on amounts paid for services performed, at least 50 percent of the services performed by the business’s employees and independent contractors (and employees of independent contractors) are performed in the QOZ.
  - If the tangible property of the business that is in a QOZ and the management or operational functions performed for the business in the QOZ are each necessary to generate 50 percent of the gross income of the trade or business.
  - Finally, taxpayers not meeting any of the other safe harbor tests may satisfy 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 QOZ.

- **Working Capital Safe Harbor.** The statutory QOZB test precludes a business from having 5 percent or more of the bases of its assets in nonqualified financial property. The initial proposed regulations provided a working capital safe harbor permitting QOZBs that acquire, construct or rehabilitate tangible real or personal property to treat cash, cash equivalents or debt instruments with a term of 18 months or less as working capital for up to 31 months if (i) there is a written plan that identifies such assets as property held for the acquisition, construction or substantial improvement of tangible property in a QOZ; (ii) there is a written schedule consistent with the ordinary business operations of the QOZB showing that the assets will be used within 31 months; and (iii) the QOZB substantially complies with such schedule. The new proposed regulations expand the working capital safe harbor and provide additional security for QOZBs waiting to deploy capital:
  - The working capital safe harbor now applies to the development of a trade or business.
  - Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action the application for which is completed during the 31-month period.
  - A QOZB may rely on overlapping or sequential applications of the working capital safe harbor as a result of multiple equity investments.

- **Intangible Property.** The statutory QOZB test requires a substantial portion of a business’s intangible property be used in the active conduct of a trade or business in the QOZ. The new proposed regulations provide that the term substantial portion means at least 40 percent.

- **Active Conduct of a Trade or Business.** The initial proposed regulations had reserved the definition of “active conduct of a trade of business.” Although the new proposed regulations still reserve such definition, they define a trade or business for purposes of Section 1400Z-2 as a trade or business within the meaning of Section 162 and specifically include as the active conduct of a trade or business the ownership and operation (including leasing) of real property. However, merely entering into a triple net-lease with respect to real property owned by a taxpayer is not considered the active conduct of a trade or business.

- **General Anti-Abuse Rule**
  The new proposed regulations contain a general anti-abuse rule aimed at ensuring taxpayers’ transactions remain consistent with the purposes of Section 1400Z-2, namely, to provide capital to underserved, low-income communities. Under the anti-abuse rule, if, based on all the facts and circumstances, the commissioner determines that a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of Section 1400Z-2, the commissioner may recast the transaction to achieve tax results consistent with Section 1400Z-2.
Open Items and Questions Left Unanswered

The new proposed regulations provide additional clarity regarding practical implementation of the opportunity zones rules, with most of the new guidance being favorable to taxpayers. However, several questions remain, and Treasury is soliciting comments on the new proposed regulations and additional questions. Of note, Treasury is requesting comments on whether a similar 12-month reinvestment grace period afforded to QOFs would be beneficial for QOZBs. Treasury also acknowledged that the granular nature of an asset-by-asset approach when determining substantial improvement of tangible property may prove onerous for certain types of businesses, and it requested comments on potential aggregate methods of determining substantial improvement.

Furthermore, except for the limited exception available to taxpayers who have held their interests in QOFs organized as partnerships or S corporations for 10 years, to the dismay of potential investors, Treasury indicated it did not believe Section 1400Z-2 grants the authority to provide for the nonrecognition of gain on any interim sales of assets by a QOF or in any case involving the sale of assets by a QOZB. Even the limited exception described above does not appear to be available for capital gain attributable to gain allocated to a QOF by a QOZB upon the sale of the QOZB’s assets. Treasury is requesting commentators provide prior examples of tax regulations that exempt realized gain from being recognized without an operative provision of the code expressly providing for nonrecognition.

Treasury also stated that within a few months of the publication of the new proposed regulations, it and the Internal Revenue Service expect to address the administrative rules applicable to a QOF that fails to maintain the required 90 percent of its assets in QOZP.

In a separate document, Treasury has requested public input on information collection and tracking related to investments in QOFs. Treasury noted that the information reported on the current version of IRS Form 8996 lacks sufficient details for it to determine the amount and type of investments that flow into an individual QOZ and the overall success of the program, and that it anticipates possible revisions to such form.

Upcoming Deadlines and Possible Near-Term Actions

It is noteworthy that Treasury is accepting comments on the new proposed regulations until July 1. Thus, interested parties still have time to provide input and submit their comments to Treasury. Our team is assisting clients and friends in this regard presently, and we would be happy to help others who would like to make their views known to Treasury as it seeks to finalize this regulatory guidance.

Note further that there is an important upcoming date on June 29. Taxpayers who are partners in partnerships or shareholders in S corporations who have been allocated flow-through capital gains from 2018 partnership or S corporation sales that were not reinvested into a QOF by the partnership or S corporation itself have until June 29 to invest up to the amount of their distributive share of those capital gains in a QOF. Additionally, taxpayers with net 2018 Section 1231 gains also have until June 29 to reinvest such gains in a QOF.

Our team at BakerHostetler would be glad to discuss any questions about QOFs, QOZs or related matters, and we are happy to help with structuring QOFs or providing other assistance to taxpayers trying to obtain the tax incentive benefits conferred by the Opportunity Zones program.

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