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How Twenty Issues Closely Tracked by the OZWG
Were Addressed in the 2nd Tranche of Proposed Regulations
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The following is a summary of how the 2nd trance of proposed regulations addressed 20 OZ guidance areas that the OZWG is closely tracking.

1. **90 percent and 70 percent asset test.** Last year's proposed regulations require that qualified opportunity funds (QOFs) and qualified OZ businesses use generally accepted accounting principles (GAAP) to calculate compliance with the 90 percent and 70 percent asset tests, if they have applicable financial statements. Mandating the use of GAAP to value tangible property is not a suitable valuation method for several reasons. The OZWG Recommended that the regulations should allow QOFs and qualified OZ businesses to elect to use unadjusted cost basis to value tangible property regardless of whether or not they have an applicable financial statement.

   Tranche 2 Regulations: For valuing the assets under the 90% test and the 70% test, the regulations allow the taxpayer to use either a financial statement method or an alternative valuation method. The taxpayer must consistently apply its selected method for all assets in a taxable year. Under the financial statement method, the taxpayer uses the value for each asset reported on the applicable financial statement. For the alternative valuation method, the value of each asset owned by a QOF is the QOF's unadjusted cost basis of the asset. See valuation of leased assets below.

2. **When must a qualified OZ business begin?** In order for investments in corporations and partnerships to qualify as opportunity zone property (OZ property), the statute requires that as of the time such interest was acquired, such corporation/partnership was a qualified OZ business (or, in the case of a new corporation/partnership, such corporation was being organized for purposes of being a qualified OZ business). The OZWG Recommended that Treasury provide guidance whether new businesses that are being organized for the purpose of being a qualified OZ business and existing businesses that are expanding within or into OZs time to acquire and/or improve tangible property and put such property to active use in OZs.

   Tranche 2 Regulations. The regulations did not provide additional guidance addressing how long a new business has to become a qualified OZ business. The regulations did make two changes to the safe harbor for working capital. First, the written designation for planned use of working capital now includes the development of a trade or business in the qualified opportunity zone as well as acquisition, construction, and/or substantial improvement of tangible property. Second, 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. The regulations also provided clarity that business may benefit from multiple overlapping or sequential applications of the working capital safe harbor.

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3. **Measuring 50 percent of gross income in OZs.** The proposed regulations require that at least 50 percent of the gross income of a qualified OZ business be derived from the active conduct of a trade or business in the OZ. The OZWG recommended that Treasury provide further guidance on how to measure that and that Treasury should provide a safe harbor for the 50 percent test that could include such things as location of employee services, location of tangible property and the location where economic value is created. The determination should not be solely based on the location of the customers of the business.

   Tranche 2 Regulations. The regulations provide 3 safe harbors for use by taxpayers determining the 50 percent trade or business test. In addition to the 3 safe harbors, the regulations also provided an additional option to consider the facts and circumstances of the business if none of the 3 safe harbors apply. The taxpayer only needs to meet one of the safe harbors in order to be considered as compliant with the 50 percent rule. The safe harbors are determined by:

      i. A ratio based on the total hours worked by the qualified OZ businesses employees, independent contractors, and employees of independent contractors in the zone divided by the total hours worked by these groups everywhere;
      ii. A ratio based on the total amounts paid by the qualified OZ businesses for services performed by its employees, independent contractors, and employees of independent contracts in the zone divided by the total amounts paid for services performed by these groups everywhere; or
      iii. A conjunctive test which considers whether the tangible property of the qualified OZ businesses is in the zone and whether the management or operational functions performed for the qualified OZ businesses in the zone are necessary to generate at 50 percent of the gross income. If both conditions are met, the qualified OZ businesses will satisfy this safe harbor.

4. **Leased property.** Under the statute, OZ property must be "purchased." However, the substantially all test for qualified OZ businesses refers to tangible property owned or leased. The QZWG Recommended guidance on how to value leased property for purposes of the substantially all test, as well as how to apply the original-use requirement for leased property.

   Tranche 2 Regulations. The regulations addressed this issue by providing specific rules for leased property as follows:

      i. The leased tangible property must be acquired under a lease after Dec 31, 2017;
      ii. Substantially all of the leased tangible property must be used in a zone during substantially all of the holding period; and
      iii. The leased property does NOT need to meet the original use or substantial improvement requirements but must be a market rate lease.

   Further, Treasury does not require that the leased property be acquired from an unrelated lessor. Treasury introduces a few anti-abuse rules for leases between related parties.

      i. No prepayments are allowed for more than a 12 month period, and
      ii. If the original use of leased tangible personal property in the QOZ does not commence with the lessee, the lessee must acquire the property during the lease or within 30 months – whichever comes earlier.

The regulations also provide guidance for valuing leased tangible property. The taxpayer may either use the applicable financial statement valuation method on an annual basis or use an alternative valuation method which is based on the present value of future lease payments.

5. **Intangible property.** The proposed regulations require that a substantial portion of the intangible property of a qualified OZ business be used in the active conduct of a trade or business in the OZ. The OZWG Recommended guidance regarding (i) the meaning of the term "substantial," (ii) the meaning of the phrase "used in the active conduct of a trade or business," (iii) a method for measuring the portion of intangible property used in a business, and (iv) a method for determining whether a business's intangible property is used in the OZ.

   Tranche 2 Regulations. The regulations define a "substantial portion" as 40 percent. The regulations defer to IRC 162 for defining active conduct of a trade or business and do not address how to measure the portion used in a business.

6. **Reasonable working capital definition.** Proposed regulations created a reasonable working capital safe harbor for qualified OZ businesses to acquire, construct and/or substantially improve tangible property. However, new and expanding operating businesses also need working capital to cover expenditures such as payroll, inventory and occupancy costs during the startup phase. The OZWG recommended a similar working capital safe harbor for operating expenditures.

   Tranche 2 Regulations. The Treasury expanded the use of working capital beyond the acquisition, construction, and/or substantial improvement of tangible property by including the "development of a trade or business" as a qualified expenditure of the working capital.

7. **Substantial improvement and aggregation of assets.** Qualified OZ business property must have its original use in an OZ with a QOF or a qualified OZ business, or the QOF or qualified OZ business must substantially improve the property. Property is treated as substantially improved by the QOF or a qualified OZ business only if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the QOF or qualified OZ business exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF or qualified OZ business. The OZWG recommended an option for the substantial improvement requirement to be met by an operating business on an aggregate basis–where the acquisition of tangible property over any 30-month period exceeds the aggregate adjusted basis of existing tangible property held by the business at the beginning of a 30-month period to facilitate the qualification of an existing operating business as a qualified OZ business.

   Tranche 2 Regulations. The regulations establishes a general rule that the substantial improvement requirement should be met on an asset-by-asset basis. The regulations invite comments on the merits and detriments of requiring the asset-by-asset basis and acknowledge situations where such a requirement may result in unfair treatment.

8. **Refinancing in excess of basis.**
   The OZWG recommendation guidance on the tax consequences for debt-financed distributions from a partnership QOF, especially due to an increase in the fair-market value of a business. At

issue is whether such distributions trigger recognition of deferred gain or affect qualification for the 10-year hold fair-market-value step-up election.

Tranche 2 Regulations. The Regulations clarify that a distribution of cash by a QOF partnership to its investors generally does not trigger gain to the extent the distribution does not exceed the investors' bases in the QOF (including debt). However, any distribution of cash or property will disqualify an investor's original transfer to the QOF partnership from beneficial QOZ treatment to the extent the overall transaction is a disguised sale if the cash contributed to the QOF partnership had been non-cash property and the exception from disguised sale treatment for certain debt-financed distributions were ignored. Ordinarily, disguised sale treatment would be presumed for distributions made within two years of the contribution, and no disguised sale treatment would be presumed for distributions made more than two years after the contribution.

9. **Substantial improvement requirement for unimproved land.** The OZWG recommended clarity whether unimproved land needs to be substantially improved to meet the substantial improvement test.

   Tranche 2 Regulations. The regulations clarify that unimproved land does NOT need to be substantially improved to qualify as QOZBP.

10. **Original use requirement and vacant buildings.** The 1st Trance of proposed regulations ask whether some period of abandonment or underuse of tangible property erases a property's history of prior use in the OZ and if so, should such a fallow period enable subsequent productive use of the tangible property to qualify as "original use." The OZWG recommended to facilitate the improvement of vacant or underused property, that prior use should be disregarded for property vacant or idle for at least a one year.

    Tranche 2 Regulations. The regulations clarify that where a building or other structure has been vacant for at least 5 years prior to purchase by a QOF or qualified OZ business, the purchased property will be considered as original use by the QOF or qualified OZ business.

11. **Treatment of IRC Section 1231 Gains.** Section 1231 gains are required to be netted with Section 1231 losses to determine the amount, if any, of capital gains a taxpayer has. This brings into question when the 180-day window to invest Section 1231 gains begins, and whether partnerships can invest gross Section 1231 gains into a QOF.

    Tranche 2 Regulations. The regulations acknowledge this issue and addressed it by allowing the taxpayer to begin the 180-day timeline on the last day of the taxable year in which the Section 1231 gains were incurred. The regulations also limited eligible Section 1231 gains to "net" section 1231 gains for a taxable year.

12. **31-month working capital safer harbor–issues beyond taxpayer's control.** The proposed regulations provide qualified OZ businesses with a 31-month safe harbor to hold funds, but make no provision to extend that period for issues beyond their control. It is not uncommon for real estate and other developments to experience delays that are beyond the businesses control–such as delayed permitting and other municipal approvals, contract disputes, supply embargoes, labor stoppages, extreme weather events and national disasters. The OZWG

requested additional flexibility to give investors comfort that businesses experiencing these unforeseen delays will not be disqualified.

Tranche 2 Regulations. The regulations provide some flexibility in the case of delay attributable to government action if the application for the pending government action is completed within the 31 month period. No other relief was provided in this matter.

13. **Residential rental property and triple net leases.** The OZWG requested clarification whether renting property pursuant to a triple-net lease can be an active trade or business and final confirmation whether operating residential rental property can be an active trade or business.

    Tranche 2 Regulations. The regulations provide that leasing real property used in a trade or business is treated as the active conduct of a trade or business for purposes of Section 1400Z-2 but stipulate that "merely" entering into a triple-net lease is not considered an active trade or business.

14. **Depreciation recapture under Section 1245.** The sale of a partnership QOF interest, after holding the investment for 10 years, will generally result in no net gain, because of the 10-year hold fair-market-value election. However, if the QOF has a direct or indirect partnership interest in depreciated personal property, it is unclear if the investor must recognize ordinary income recapture and a corresponding capital loss. This issue is particularly significant for the renewable energy community.

    Tranche 2 Regulations. The regulations provide that when a taxpayer makes the fair market value election, the basis of the partnership interest is adjusted to an amount equal to the fair market value of the interest, including debt. The regulations also provide that immediately prior to the sale the basis of the QOF partnership assets are also adjusted, assuming that a valid section 754 election had been in place. This provision appears to address the unpleasant outcome of ordinary income recapture and a corresponding capital loss. The Regulations do not address whether a qualified OZ business may also adjust its assets

15. **Consolidated group rules.** Neither the statute nor the regulations address whether capital gains of one member of a consolidated return group of corporations can be treated as capital gain of other members of the consolidated return group so that gains may be aggregated under a single deferral election by the consolidated return group for purposes of the OZ statute. The OZWG requested guidance regarding the proper treatment of QOF investments within a consolidated group.

    Tranche 2 Regulations. The regulations provide that a QOF C corporation can be the common parent of a consolidated group, but it cannot be a subsidiary member of a consolidated group. Therefore a QOF C corporation owned by members of a consolidated group is not a member of that consolidated group. The regulations also provide that the same member of the group must both engage in the sale of a capital asset giving rise to gain and timely invest an amount equal to some or all of such gain in a QOF in order to qualify for deferral. This position raises issues with corporations who have already incorporated a QOF subsidiary within their consolidated group.

16. **Reasonable time to invest and working capital allowance.** QOFs need time to make investments. The OZ statute explicitly states that Treasury guidance is needed to provide a

reasonable time for a QOF to reinvest the return of capital from the sale of investments in OZ property. Likewise, QOFs need adequate time to assemble and underwrite initial OZ property investments. Treasury regulations provided qualified OZ businesses a safe harbor, allowing funds to be held for up to 31 months if there is a written plan in place that follows specific requirements. A similar safe harbor is needed for QOFs.

Tranche 2 Regulations. The regulations provide relief in this instance by allowing the QOF to apply the 90 percent asset test as scheduled without taking into consideration any investments received in the 6 month period prior to the semi-annual asset test. Effectively, each new capital investment in an existing QOF has at least six months before the capital must be converted into Qualified Opportunity Zone Property.

17. **Interim gains at fund level.** In the first tranche of guidance, Treasury asked whether interim gains should be subject to tax. If yes, an additional question is whether a partnership operating as a QOF can make the election on behalf of its investors to reinvest, rather than being required to make a distribution and for the investors to then reinvest in the same or another QOF.

    Tranche 2 Regulations. The regulations stipulate that while a qualifying reinvestment does not negatively impact the qualified opportunity zone benefits, the Treasury does not have the authority to provide similar treatment with regards to recognizing gain on the sale or disposition of assets under sections 1001(a) and 61(a)(3). The regulations invite comments on prior examples of tax regulations that exempt realized gain from being recognized by a taxpayer without an express operative provision of the IRC.

18. **Time to reinvest interim gains for purposes of 90 percent test.** If QOZP is sold for cash, it is no longer a qualified investment for the 90 percent test–but the OZ statute allows a reasonable time to reinvest. The OZWG recommended that Treasury provide a definition of "reasonable time," which should be at least one year.

    Tranche 2 Regulations. The regulations clarify that a QOF has 12 months from a sale or disposition of qualified property to reinvest the proceeds from the transaction in other qualified opportunity zone property. The proceeds from the sale or disposition must be continuously held in cash, cash equivalents, and debt instruments with a term of 18 months or less

19. **Exit approach in wind-down period.** The OZ statute provides a fair-market-value step-up benefit only if a taxpayer sells its investment in a QOF. That requirement is counter to the way funds generally unwind. The OZWG requested that Treasury issue rules that provide that if a QOF disposes of assets after 10 years, pursuant to a plan of liquidation, then the QOF investors can treat such sales in a manner equivalent to selling an interest in a QOF.

    Tranche 2 Regulations. The regulations provide an answer to this issue specific to partnerships and S corps. A taxpayer who holds a partnership or S corp stock interest in a QOF may elect to exclude from its gross income some or all of the gain from the sale or disposition QOZP as long as the sale or disposition occurs after the 10 year holding period. The excluded amount would be treated as income which increases the partner's or shareholder's bases. The regulations do not address whether the exclusion applies if a qualified OZ business disposes of property.

20. **Appreciated property contribution and carried interest.** The statute and proposed regulations do not specify whether investments in QOFs must be cash, or can include property or services. The OZWG requested guidance whether eligible investments include contributions of property, and suggested that anti-abuse rules are needed to regulate contributions of appreciated property.

    Tranche 2 Regulations. The regulations provide that property contributions are eligible. Where the investor transfers property to the QOF in a non-recognition transaction, the amount of the qualifying investment equals the lesser of the investor's adjusted basis in the equity received in the transaction and the fair market value of the equity received in the transaction. The portion of the QOF investment in excess of this amount is not treated as a qualifying investment (i.e., the investor will have a "mixed-fund investment. With respect to services, the regulations clarify that an investment of services in exchange for a partnership interest in a QOF or qualified OZ business does not qualify for the 1400Z-2 benefits.