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Second Set of Opportunity Zone Regulations Provide Helpful Guidance

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INTRODUCTION

From the moment that the Opportunity Zone program, contained in §1400Z-2,[1] was enacted, potential investors and sponsors have clamored for guidance from the Internal Revenue Service (IRS) on a plethora of issues.[2] Proposed regulations issued last October[3] provided guidance on certain critical issues but left many questions unanswered.

A second set of proposed regulations (Regulations) released on April 17, 2019, provide rules on several of those issues, including topics of widespread interest such as the 10-year exit mechanism, leasing, interim gains, and carried interests; several of these rules—but not all—are favorable to taxpayers. A large portion of the Regulations address issues that will be of interest only to a minority of taxpayers, *viz*., formation of a QOF[4] as a corporation or real estate investment trust (REIT), and various corporate and REIT transactions including tax-free reorganizations, tax-free spin-offs, and capital gain dividends by REIT's.[5]

Among other things, the Regulations:

- Clarify the 10-year exit rules and provide an alternate mechanism for an investor to exit a QOF investment after 10 years;
- Contain comprehensive rules concerning leased property;
- Provide 12 months for a QOF to reinvest "interim gains," but require investors to pay tax currently on such gains;
- Provide that so-called "carried interests" do not qualify for the benefits of the OZ program;
- Clarify the original use and substantial improvement requirements;
- Allow refinancing proceeds to be distributed to investors in a QOF partnership in certain circumstances;
- Define several transactions (called "inclusion events") where deferred gain will be recognized prior to December 31, 2026, and list other transactions that will not be inclusion events;
- Provide safe harbors for the 50% gross income test; and
- Allow new capital received by a QOF to be excluded from the 90% asset test for six months.

The Regulations will be effective on the date published as final regulations in the Federal Register, but

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[1] As added by §13823 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (Dec. 22, 2017). All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[2] A detailed description of the benefits and requirements of the Opportunity Zone program is contained in three articles by the author published in the *Tax Mgmt. Real Estate Journal*, Vol. 34, No. 2 (Feb. 7, 2018), Vol. 34, No. 7 (July 4, 2018) and Vol. 34, No. 11 (Nov. 7, 2018).

[3] 83 Fed. Reg. 54,279 (Oct. 29, 2018).

[4] Defined terms used in the article are as follows: QOF is a "qualified opportunity fund" as defined in §1400Z-2(d)(1); OZ is a "qualified opportunity zone" as defined in §1400Z-1(a); QOZB is a "qualified opportunity zone business" as defined in §1400Z-2(d)(3)(A); QOZBP is "qualified opportunity zone business property" as defined in §1400Z-2(d)(2)(D)(i); and QOZP is "qualified opportunity zone property" as defined in §1400Z-2(d)(2)(A).

[5] These provisions are not discussed.

special rules[6] generally permit taxpayers to rely on the Regulations immediately if they are applied consistently and in their entirety.

The provisions of the Regulations listed above are explained in more detail below.

CLARIFICATION OF 10-YEAR EXIT RULES AND ALTERNATE EXIT MECHANISM

Potentially the largest benefit under the OZ program is the ability of an investor to permanently exclude gain attributable to the appreciation of his or her QOF interest if held for at least 10 years. Unfortunately, the statute requires that the investor sell the interest in the QOF to achieve this benefit, which would be a non-customary way to dispose of real property held by the QOF or QOZB, and unworkable in multi-project funds. Also, there was uncertainty as to whether debt was taken into account in determining the fair value of the interest (which would be necessary to avoid realizing income from a negative capital account) and whether amounts that would be treated as ordinary income under normal tax rules on the sale of a QOF partnership interest would be excluded.

On the latter question, the Regulations provide relief. Just prior to the sale of a QOF partnership interest that has been held at least 10 years, the basis of all of the assets of the QOF are deemed to be stepped up to fair market value.[7] The result of this deemed step up is that no amounts received by an investor on the sale of the QOF interest will be treated as ordinary income under the so-called ''hot asset'' rules in §751.

A short detour into §751 is necessary to explain the importance of this rule. Many investors may believe that, even without this new rule, there could never be ordinary income realized on sale of a QOF interest after 10 years since, by definition, there is no gain. However, §751 does not work that way. Assume that A sells her 50% partnership interest with a basis of $130 for $130, resulting in no gain. Assume that, if the partnership sold its assets at that time, it would realize a $30 gain ($15 allocable to A) from the sale of certain ordinary-income type assets (hot assets) such as unrealized receivables, inventory items, depreciation recapture on equipment under §1245, and other ordinary income-type items. A is therefore deemed to have $15 of ordinary income from the sale of her partnership interest, and a $15 capital loss.[8] The new rule prevents this result since on the deemed sale of the partnership's assets there is no gain attributable to hot assets. This will be especially important for operating businesses, which are likely to have a significant amount of hot assets; a real estate business can also benefit from the new rule, although the amount of its hot assets is likely to be small.

The Regulations confirm that debt is included in the valuation of the QOF interest,[9] which prevents a negative capital account from being ''recaptured.''

The Regulations also provide an alternate approach[10] that will solve half of the problem related to selling a QOF interest: if a QOF organized as a partnership sells property and allocates the capital gain to its partners on Schedule K-1, those partners who have held their interests for at least 10 years can exclude such capital gain from their income.[11] Note that there is no requirement that the QOF has held its assets for 10 years or any minimum length of time to take advantage of this rule. Unlike the new rule for selling the QOF interest, any gain from the sale of hot assets will not be excluded, but this is likely to be small for a real estate business. Because most QOF's will hold only interests in QOZB's, that means that those QOZB partnership interests most be sold, rather than real property held by the QOZB. It is not clear why this alternate provision was not extended to a QOZB, which would have permitted direct sales of the real property.

This rule will allow interests in separate QOZB's to be sold at different times, but will still require the buyer to purchase an interest in an entity, rather than the fee interest in the property.[12]

LEASING RULES

The statute contains only one reference to leased property, *viz.*, that ''substantially all of the tangible

[6] Prop. Reg. §1.1400Z-2(b)-1(i); Prop. Reg. §1.1400Z-2(f)-1(d); Prop. Reg. §1.1400Z-2(g)-1(g). Note that Prop. Reg. §1.1400Z-2(a)-1 and Prop. Reg. §1400Z-2(d)-1 are amendments to regulations proposed last October, and those regulations permitted reliance on these sections. Prop. Reg. §1.1400Z-2(c)-1, concerning the various changes to the 10-year exit rule, are effective only when finalized, but will not be needed until 2028 at earliest.

[7] Prop. Reg. §1.1400Z-2(c)-1(b)(2). The deemed step-up rule does not specifically permit a subsidiary QOZB of a QOF to step-up the basis of its assets, but the provision would not operate as intended if this were not the case. Hopefully, the final regulations will correct this glitch.

[8] *See* Prop. Reg. §1.1400Z-2(c)-1(d)(2) *Ex.* 2.

[9] Prop. Reg. §1.1400Z-2(c)-1(b)(2).

[10] Prop. Reg. §1.1400Z-2(c)-1(b)(2)(ii)(A)(*1*).

[11] There is no requirement that the QOF distribute the cash to its investors (although based on a public statement by a senior government official it appears that this option was not contemplated). If the QOF retained the cash and reinvested it, it is unclear how such reinvestment is treated under the OZ program rules.

[12] It may be possible to liquidate the QOZB and then have the QOF sell the real property, but this would require two real estate transfers and possible additional transfer or conveyance fees.

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property owned or leased''[13] by a QOZB must be QOZBP. Although this seemed nothing more than a requirement that leased property be taken into account for the substantially all test the same as owned property, the brevity of the provision caused some to fear that the IRS would impose onerous requirements concerning the qualification or valuation of leased property. For the most part, the Regulations propose sensible rules concerning leased property.

Consistent with the statutory directive, the Regulations treat leased property held by a QOZB (as lessee) as tangible property for purposes of the 70% substantially all test,[14] even though a leasehold interest would normally be carried as an intangible asset on the balance sheet (if at all). The Regulations apply the same rule for the 90% asset test for a QOF,[15] despite the fact that there is no similar statutory directive. This is likely to be a helpful rule for those QOF's that conduct business directly (as opposed to through a QOZB), since it will allow leased property to be included as a good asset for the 90% asset test.

As to the qualification of leased property as QOZBP, the Regulations modify the rule that the property must be acquired by purchase after December 31, 2017, with a requirement that the property be leased after December 31, 2017.[16] In addition, all leases (whether or not the property is leased from a related party) must be on market rate terms for the locale, as determined under §482.[17] This section generally imposes an arm's length standard on transactions between parties under common control. Reg. §1.482-2(c) provides that a lease of tangible property must have an arm's length rental charge, determined as ''the amount of rent which . . . would have been charged for the use of the same or similar property . . . in independent transactions with or between unrelated parties . . . .''[18] The reference to §482 with respect to leases between related parties is understandable, but is puzzling as applied to leases between unrelated parties. First, since by definition a lease between parties not under common control would satisfy the arm's length standard, it would seem that every lease between unrelated parties would satisfy the rule by definition. Second, terms of certain leases between unrelated parties may differ from other leases of similar properties in the community, e.g., a lessee may need to pay a premium rent solely because property is located in an OZ, or, conversely, a governmental agency may agree to lease land to a QOZB at a bargain rent to facilitate a project—it is not clear why either of these should be problematic under the OZ program.

The Regulations permit property to be leased from a related person (unlike owned property, which must be purchased from an unrelated person), but impose two additional requirements if the lessor and lessee are related:[19] (1) the lessee cannot make a prepayment relating to the use of property that exceeds 12 months, and (2) for leased personal property, if the lessee is not the original user of the property in an OZ, the lessee must acquire within 30 months (or during the lease term, if shorter) other tangible property with a value at least equal to the leased personal property. The purchased property and the leased property must be used substantially in the same OZ.[20] Leased real property (other than unimproved land) does not qualify as QOZBP if, at the time the lease is entered into, there was a plan, intent, or expectation for the property to be purchased by the lessee at other than fair market value at the time of purchase without regard to prior lease payments.[21]

Improvements to leased property by the lessee are treated as purchased property satisfying the original use test.[22]

For purposes of both the 70% substantially all test for a QOZB and the 90% asset test for a QOF, leased property can be valued in one of two ways: If the QOZB or QOF has an ''applicable financial statement,''[23] it can use the value on such statement if it requires an assignment of value to the lease (and for

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[13] §1400Z-2(d)(3)(A)(i).

[14] Prop. Reg. §1.1400Z-2(d)-1(d)(3)(ii)(A). The same test is applied to a QOF by Prop. Reg. §1.1400Z-2(d)-1(c)(9).

[15] Prop. Reg. §1.1400Z-2(d)-1(b)(2) and (3).

[16] Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(B)(*1*); Prop. Reg. §1.1400Z-2(d)-1(c)(4)(i)(B)(*1*).

[17] Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(B)(*2*); Prop. Reg. §1.1400Z-2(d)-1(c)(4)(i)(B)(*2*).

[18] Reg. §1.482-2(c)(2)(i). Under a special rule for subleases in Reg. §1.482-2(c)(2)(iii), an arm's length rental charge will be considered to be equal to the rent and other deductions of the lessor, unless a more appropriate charge is established.

[19] Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(B)(*4*) and (*5*); Prop. Reg. §1.1400Z-2(d)-1(c)(4)(i)(B)(*4*) and (*5*). A lease with a prepayment, whether or not the parties were related, would have to be structured to avoid a ''section 467 loan,'' as described in Reg. §1.467-4, to avoid creating impermissible nonqualified financial property.

[20] Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(B)(*5*); Prop. Reg. §1.1400Z-2(d)-1(c)(4)(i)(B)(*5*).

[21] Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(E); Prop. Reg. §1.1400Z-2(d)-1(c)(4)(i)(E).

[22] Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(C); Prop. Reg. §1.1400Z-2(d)-1(c)(7)(ii).

[23] An ''applicable financial statement'' is defined as a financial statement that is the taxpayer's primary financial statement for the year if (i) it is prepared in accordance with U.S. GAAP and is filed with the Securities and Exchange Commission, or (ii) the taxpayer makes significant business use of the financial statement (as described in detail in Reg. §1.475(a)-4(j)) and it is either prepared in accordance with U.S. GAAP and required to be provided to a federal government agency other than the IRS, or is a certified audited financial statement prepared in accordance with U.S. GAAP and given to creditors, equity holders or provided for other sub-

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purposes of the 90% asset test, it is prepared in accordance with GAAP).[24] Alternatively (whether or not the entity has an applicable financial statement), the lease can be valued on a present value basis.[25] Under this method, the present value is determined at the time the lease is entered into by discounting all payments under the lease using a discount rate equal to the applicable federal rate[26] based on the lease term, including any lessee extensions at a pre-defined rent. Once calculated, the value is used for the life of the lease.

Both valuation methods result in a qualifying asset that did not require the expenditure of cash.

INTERIM GAINS

The statute directed the IRS to prescribe rules ''to ensure a qualified opportunity fund has a reasonable period of time to reinvest the return of capital from investments in . . . qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone property . . . .''[27] This has been referred to as the ''interim gains'' issue, since the QOF or QOZB would recognize gains prior to the end of the 10-year holding period.

The Regulations provide that if a QOF reinvests proceeds from a return of capital from a QOZB or the sale of QOZP in other QOZP within 12 months, the reinvested proceeds are treated as satisfying the 90% asset test, if they are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less.[28] If reinvestment of the proceeds is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of the 12-month requirement.

Investors were hoping that the IRS would also allow them to exclude interim gains from income.[29] However, as explained in the preamble to the Regulations, the IRS believed that they did not have authority to do this.

Therefore, the solution provided by the Regulations will provide flexibility for a QOF to exchange its properties during the 10-year period, but at a cost. The QOF could require that the investors pay the tax from their own resources (unless the partnership agreement of the QOF provided otherwise), but if the QOF wanted to distribute a portion of the proceeds to investors to cover the tax, it would need to do this before the next testing date following the sale or return of capital so that such amount would not be included in the denominator of the test fraction.

CARRIED INTERESTS

An interest in partnership profits that exceeds the capital contributed by a partner, usually issued in exchange for services rendered or to be rendered by the partner to the partnership, is sometimes referred to as a ''carried interest.''[30]

A reasonable interpretation of the statute and the first set of proposed regulations suggested that a carried interest in a QOF would qualify for the benefits of the OZ program, as long as the holder also invested more than a *de minimis* amount of qualifying capital gains. The Regulations, however, take a different view, and provide that a carried interest in a QOF is not an eligible interest, and will not qualify for any OZ benefits.[31]

The carried interest does not disqualify the QOF, but instead is treated the same as the investment of non-qualifying capital into a mixed fund. Therefore, to avoid the additional accounting burden imposed on a mixed fund, a sponsor should consider taking a carried interest at the QOZB instead.

ORIGINAL USE AND SUBSTANTIAL IMPROVEMENT REQUIREMENTS

One of the requirements for property to be QOZBP is that either the QOF or QOZB be the original user of the property in the OZ or that the property be sub-

stantial non-tax purposes and the taxpayer reasonably anticipates that it will be relied upon for the purposes for which it was given.

[24] Prop. Reg. §1.1400Z-2(d)-1(d)(3)(ii)(B)(*2*)(*ii*); Prop. Reg. §1.1400Z-2(d)-1(b)(2)(ii). Pursuant to Prop. Reg. §1.1400Z-2(d)-1(d)(3)(ii)(C), a QOZB can use the same method used by its QOF parent in certain cases.

[25] Prop. Reg. §1.1400Z-2(d)-1(d)(3)(ii)(B)(*3*)(*iii*); Prop. Reg. §1.1400Z-2(d)-1(b)(3)(iii).

[26] The current applicable federal rate (which changes monthly) for leases with monthly rents is 2.49% for leases with a term not over three years, 2.52% for leases with a term over three years but not over nine years, and 2.85% for leases with a term over nine years.

[27] §1400Z-2(e)(4)(B).

[28] Prop. Reg. §1.1400Z-2(f)-1(b).

[29] Note it appears that an investor could defer this gain (if realized before 2027) by investing in the same or another QOF, but the QOF partnership could not defer the gain by investing in a QOF, because the statute prohibits a QOF from investing in another QOF. §1400Z(d)(1).

[30] Some taxpayers may distinguish a ''promote,'' i.e., a share of cash received by the sponsor in excess of its share of capital, usually received after the investors have received a specified return, from a carried interest, but it appears that the IRS would consider this the same as a carried interest for purposes of the OZ provisions.

[31] Prop. Reg. §1.1400Z-2(a)-1(b)(9)(ii).

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stantially improved;[32] generally, the substantial improvement test requires doubling the basis of the property over a 30-month period.[33]

The first set of proposed regulations and Rev. Rul. 2018-29, issued in conjunction therewith, provided that land can never qualify for the original use test, but provided a favorable rule for the acquisition of land with an existing building, providing that the substantial improvement test applied only to the building, and there was no separate substantial improvement test with respect to the land.

The Regulations provide additional guidance on this topic. There is no substantial improvement requirement with respect to unimproved land.[34] Similarly, there is no substantial improvement test with respect to a building that has been vacant for an uninterrupted period of at least 5 years,[35] since the QOF or QOZB will be considered the original user of such building. The Regulations also contain a favorable rule for used tangible property,[36] providing that a QOF or QOZB will be treated as the original user of such property if the prior use was not in an OZ. It is unclear if property previously placed in service at a location that was subsequently designated as an OZ would be treated as previously placed in service in an OZ for this purpose; if not, then a building that was vacant at the time an OZ was designated would qualify for original use (and thus would not need to be substantially improved) when acquired by a QOZB and placed in service in the newly designated OZ, without regard to the five-year rule discussed above.

There are no original use or substantial improvement requirements for leased property between unrelated parties. A modified substantial improvement test applies to certain leased personal property between related parties.[37]

One of the biggest disappointments with the Regulations was that they did not permit the substantial improvement test to be applied on an aggregate basis, and thus the test must be applied on an asset-by-asset basis. For example, if land with three existing buildings were acquired, each building must separately satisfy the substantial improvement test. Similarly, if multiple items of personal property were purchased (and they did not qualify for the special ''original use'' test because they had previously been used in an OZ), improvements to one item of equipment that exceeded its cost could not be applied to satisfy the substantial improvement test for another item of equipment that required only minimal rehabilitation.

DISTRIBUTION OF REFINANCING PROCEEDS

Under normal partnership tax rules, a refinancing by a partnership of its property and distribution of excess proceeds to its partners is generally a non-taxable event. The rationale for this favorable treatment is that the partners remain responsible, from both an economic and tax standpoint, for the debt. There was nothing in §1400Z-2 to suggest that these normal rules would not apply to a QOF that was organized as a partnership, but informal statements by IRS personnel prior to release of the Regulations indicated that this common practice might be viewed as abusive in the context of the OZ program.

The Regulations address the issue obliquely by reference to the so-called ''disguised sale'' rules of §707(a)(2) and regulations thereunder.[38] Generally, the disguised sale rules treat a contribution of property to a partnership and a related distribution of cash as a sale of the property for tax purposes.

The Regulations apply the rules in Reg. §1.707-3 through §1.707-5 to the distribution of the refinancing proceeds, with two important changes: (i) the cash contributed by the investor is treated as non-cash property, and (ii) the amount of the debt included in the tax basis of the investors is deemed to be zero. To the extent this analysis results in a deemed disguised sale, the original contribution of cash is not treated as a qualifying interest in the QOF.

The result of this round-about approach is that the distribution of debt financed proceeds will likely not disqualify the initial investment if the distribution is at least two years after the last contribution of cash by investors to the QOF.[39] This is based on a presumption in Reg. §1.707-3(d) that if a contribution and distribution are more than two years apart, the transfers are not a disguised sale unless the facts and circumstances clearly establish otherwise. An example pur-

[32] §1400Z-2(d)(2)(D)(i)(II).

[33] §1400Z-2(d)(2)(D)(ii).

[34] Prop. Reg. §1.1400Z-2(d)-1(d)(4)(ii)(B); Prop. Reg. §1.1400Z-2(d)-1(c)(8)(ii)(B). However, unimproved or minimally improved land acquired with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase is not a qualified asset. Prop. Reg. §1.1400Z-2(d)-1(f).

[35] Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(C); Prop. Reg. §1.1400Z-2(d)-1(c)(7)(i). Investors were hoping for a rule similar to Reg. §1.1394-1(h) which provided that the use of property vacant for one year which included the designation of the enterprise zone in which it was located would be treated as original use.

[36] Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(C); Prop. Reg. §1.1400Z-2(d)-1(c)(7)(i).

[37] This requirement is discussed under ''Leasing Rules,'' above.

[38] Prop. Reg. §1.1400Z-2(a)-1(b)(10)(ii)(A)(*2*).

[39] This result was confirmed by a public statement by a senior government official.

porting to illustrate this rule[40] only restates the rule and does not provide any clarity. An example on a different topic,[41] *viz.*, on whether a distribution from a partnership causes an "inclusion" triggering a part of an investor's deferred gain, can be interpreted as supporting the result: A and B each make a $200 qualifying contribution to QOF on January 1, 2019. On November 18, 2022, QOF borrows $300 and distributes $50 to A. The example holds that A does not have an inclusion event because his outside tax basis of $150 (the original basis of zero plus $150 due to the allocation of half of the debt) exceeds the amount of the distribution.

INCLUSION EVENTS

Capital gains deferred under the program are subject to tax on December 31, 2026, except that 10% of the original deferred gain is forgiven if the QOF investment has been held for at least 5 years before that date, and an additional 5% is forgiven if the QOF investment has been held for at least 7 years.[42] A sale of the QOF investment prior to December 31, 2026 will trigger all or part of the deferred gain.[43]

The Regulations define several other events (called "inclusion events") that, if they occur prior to December 31, 2026, will trigger the deferred gain, and list other events that are not inclusion events.[44]

The following events or transactions **are** inclusion events:

- The transfer of a QOF interest by gift, either outright or in trust, and regardless of whether the donee is taxable or tax-exempt;
- The termination of the status of a grantor trust holding a QOF interest, except due to the death of the grantor;
- The distribution of cash or property by a QOF that is a partnership in excess of the investor's tax basis in the QOF (or in any upper-tier partnership);
- A transfer of an interest in a partnership that is an investor in a QOF (through any number of tiers) that would be an inclusion event if the interest transferred were a direct interest in the QOF;
- The distribution of cash or property by a QOF that is a corporation in excess of the amount that is a dividend or recovery of basis;
- The contribution of a QOF interest to a corporation (even if tax-free under §351);
- An aggregate change in ownership of an S corporation that is an investor in a QOF of more than 25%; and
- Conversion of an S corporation to a partnership or disregarded entity.

The following events or transactions **are not** inclusion events:

- The transfer of a QOF interest by reason of the investor's death, including a transfer to the decedent's estate, a distribution by the decedent's estate, a distribution by a trust of the decedent made by reason of death, the transfer of property to a co-owner by operation of law, and any other transfer at death by operation of law (the decedent's holding period also carries over for purposes of the OZ provisions);
- The transfer of a QOF interest to a grantor trust;
- The contribution of a QOF interest to a partnership under §721;
- The distribution of cash or property by a QOF that is a partnership not in excess of the investor's tax basis in the QOF;[45]
- The merger or consolidation of a partnership under §708(b)(2)(A);
- the election or revocation of an S election for a corporation which is either a QOF or an investor in a QOF; and
- various changes to trusts holding S corporation stock.

SAFE HARBORS FOR 50% GROSS INCOME TEST

At least 50% of the gross income of a QOZB must be from the active conduct of a trade or business.[46] The first set of proposed regulations expanded this requirement by requiring that such income be derived in an OZ. Concerns were expressed that this expansion

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[40] Prop. Reg. §1.1400Z-2(a)-1(b)(10)(iv)(C) *Ex.* 3.

[41] Prop. Reg. §1.1400Z-2(b)-1(f)(10) *Ex.* 10.

[42] §1400Z-2(b)(1)(B); §1400Z-2(b)(2)(B)(iii) and (iv).

[43] §1400Z-2(b)(1)(A).

[44] Prop. Reg. §1.1400Z-2(b)-1(c).

[45] Prop. Reg. §1.400A-2(b)-(1)(c)(6)(iii), Prop. Reg. §1.1400Z-2(b)-1(f)(10) *Ex.* 10. This is the reverse of the similar inclusion event, and is by far the more important provision. It confirms that distributions of operating income or refinancing proceeds do not trigger deferred gain to the extent that an investor has outside tax basis in his or her QOF interest, determined by including an investor's share of debt in basis per normal partnership tax rules. Note that this rule can be overridden by the special rule on distribution of refinancing proceeds discussed under "Distribution of Refinancing Proceeds," above.

[46] §1400Z-2(d)(3)(A)(ii), by reference to §1397C(b)(2).

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would prevent operating businesses that have locations and personnel within and without an OZ from participating in the program.

The Regulations continue the requirement that at least 50% of the gross income must be from the active conduct of a trade or business within an OZ,[47] but provide three safe harbors (only one of which must be satisfied) for determining where gross income is sourced that may allow some operating businesses to take advantage of the program.[48]

Under the first safe harbor, the gross income test will be deemed to be satisfied if at least 50% of the services performed for the QOZB for the taxable year are performed in an OZ, measured by the number of hours performed by employees, independent contractors and employees of independent contractors. It appears that qualifying services performed in any OZ will count, and not just services performed where the QOZB has its headquarters.

Under the second safe harbor, the gross income test will be deemed to be satisfied if at least 50% of the services performed for the QOZB for the taxable year are performed in an OZ, measured by the amount paid for services performed by employees, independent contractors and employees of independent contractors. An example in the preamble to the Regulations illustrates this safe harbor. A software developer has a campus within an OZ and a service center outside the OZ. More total hours are performed by employees at the service center, but more total compensation is paid to the software developers and management working at the OZ campus.

The third safe harbor requires a subjective determination (and thus does not actually function as a safe harbor): if the tangible property located in an OZ and the management or operational functions performed in an OZ are each necessary for the generation of at least 50% of the gross income of the QOZB, then the gross income test will be deemed to be satisfied. An example in the Regulations[49] provides little clarity: officers and employees of a landscaping business headquartered in an OZ manage its operations (conducted within and without an OZ) from the OZ headquarters, and the equipment and supplies are stored at such location (but presumably used outside the OZ). The example concludes that these factors, taken together, constitute a material factor in the generation of the income of the business.

In addition to the three safe harbors, a QOZB can use a facts and circumstances test to determine where its gross income is derived.

[47] The rationale given in the preamble to the Regulations for this position is not convincing.

[48] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(i).

[49] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(i)(E)(*1*) Ex. 1.

RELIEF FROM SATISFACTION OF 90% ASSET TEST FOR NEW CAPITAL

A QOF must have at least 90%, on average, of its assets invested in qualifying property as of June 30 and December 31 each year (for a calendar year taxpayer, subject to a special rule for the first year). This caused a problem for QOF's receiving capital late in the applicable six-month period, since it required the QOF to deploy the capital very rapidly. For example, if a QOF received capital on December 15, it had to deploy at least 90% of it into qualifying assets by December 31 to avoid a penalty.

Investors had requested 12 months to deploy new capital without regard to the testing dates. The Regulations provide 6 months instead, but in a backwards manner.[50] Instead of simply allowing 6 months to deploy new capital without regard to the testing dates, the Regulations ignore new capital as of a testing date if it was received by the QOF not more than 6 months before and has been held in cash, cash equivalents, or debt instruments with a term of 18 months or less. Where the QOF has previously deployed capital, this approach should work, since only the previously deployed capital will be counted. However, if this is the first draw-down of capital by the QOF, both the numerator and denominator of the testing fraction would be zero, resulting in an undefined mathematical term—presumably in this case the testing date will be disregarded.

OTHER RULES

The Regulations provide several other rules, summarized below:

- The Regulations define the term ''substantially all'' to be 90% when used to define a holding period[51] and 70% when it refers to use of assets,[52] and define ''substantial portion'' (concerning intangible property) as 40%;[53] the first set of proposed regulations defined the term for only one purpose;
- The 31-month safe harbor provided in the first set of proposed regulations for the acquisition, construction and improvement of tangible property is expanded to include development of a trade or

[50] Prop. Reg. §1.1400Z-2(d)-1(b)(4).

[51] Prop. Reg. §1.1400Z-2(d)-1(c)(5); Prop. Reg. §1.1400Z-2(d)-1(d)(2)(iii).

[52] Prop. Reg. §1.1400Z-2(d)-1(c)(6); Prop. Reg. §1.1400Z-2(d)-1(d)(2)(iv).

[53] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(ii)(A). This generously low percentage will be especially helpful to operating businesses that may use a large percentage of their intangible property outside an OZ.

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business, so that it can be used by both real estate and non-real estate QOZB's;[54] a provision was added providing that delay due to waiting for governmental action (where an application for such action was complete) will not invalidate the safe harbor—it would have been helpful if delays due to extreme weather and other force majeure events were also excused; the Regulations clarified[55] that there can be overlapping 31-month periods with respect to separate contributions to a QOZB used for different projects;

- The Regulations provide that a triple net lease of real estate does not constitute a qualifying trade or business,[56] apparently adopting the rationale of Notice 2006-77, §3.02(3)(c) and PLR 201618008;
- The Regulations allow a taxpayer acquiring an interest in a QOF from another investor to make a gain deferral election to the extent that the acquirer has timely capital gains;[57] the acquirer would begin a new holding period for purposes of the OZ provisions;
- A consolidated subsidiary can be a QOF, but the Regulations generally treat the QOF as an unconsolidated subsidiary for non-QOF tax purposes.[58] This likely will inhibit the use of consolidated subsidiaries as QOF's going forward, but has created enormous problems for consolidated subsidiaries that were formed last year with the intent to elect QOF status;
- The troublesome ''applicable financial statement'' requirements, added by the first set of proposed regulations, are made optional by the Regulations;[59]
- The Regulations extend the start of the 180-day period to invest gains constituting net §1231 gains to the last day of the taxable year, since a taxpayer will not know the net gains and losses from §1231 transactions until then;[60]
- Approval of so-called ''feeder funds,'' requested by many sponsors, was not provided by the Regulations; provisions[61] that would allow formation of a fund to hold QOF interests does not serve the same purpose;
- Real property that straddles an OZ boundary will qualify if the square footage located within the OZ is substantial as compared to the square footage outside the OZ, and the property within and without the OZ are contiguous;[62] and
- A broad anti-abuse rule[63] will allow the IRS to recast a transaction if it finds that a significant purpose of the transaction is to achieve a tax result that is inconsistent with the purpose of §1400Z-2.

CONCLUSION

The Regulations provide several additional needed rules, which for the most part are favorable. The biggest disappointments for investors are the limited relief provided for interim gains, the rule disqualifying carried interests, and the requirement to apply the substantial improvement test on an asset-by-asset basis. The Regulations do not provide guidance, of course, on all of the issues where taxpayers requested guidance, and do not contain reporting requirements. It is not clear if these issues will be addressed in a third set of proposed regulations or if such guidance will be provided in a different manner.

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[54] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(iv).

[55] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(iv)(D) and (E)(2) *Ex.* 2.

[56] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(ii)(B)(*2*). It should be possible to avoid this proscription by modifying the typical triple net lease by imposing some management functions and cost burden on the lessor.

[57] Prop. Reg. §1.1400Z-2(a)-1(b)(9)(iii). Note that the acquired QOF interest would be an eligible interest under the general rules only if the acquirer's capital gain was realized before 2027.

[58] Prop. Reg. §1.1400Z-2(g)-1.

[59] Prop. Reg. §1.1400Z-2(d)-1(b); Prop. Reg. §1.1400Z-2(d)-1(d)(3)(ii)(B). Even if a QOF or QOZB has an applicable financial statement, it can choose to use unadjusted cost basis instead for purposes of the 90% asset test or 70% substantially all test, or the present value method for leased property.

[60] Prop. Reg. §1.1400Z-2(a)-1(b)(2)(iii). Although not addressed in the Regulations, it appear that a partnership can invest its net §1231 gains without regard to §1231 losses recognized by its partners.

[61] Prop. Reg. §1.1400Z-2(b)-1(c)(6)(ii)(B); Prop. Reg. §1.1400Z-2(b)-1(g)(3)(ii).

[62] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(viii). The preamble to the Regulations indicates that the square footage located within the OZ will be substantial if it exceeds the square footage located outside the OZ.

[63] Prop. Reg. §1.1400Z-2(f)-1(c).

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