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Client Alert

Tax

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Qualified Opportunity Funds: Answers and Questions (Update #3–Final Regulations Released)

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On December 19, 2019, the IRS released final regulations that provide further clarity regarding the application of the qualified opportunity fund rules. This Client Alert updates our April 23, 2019; October 23, 2018; and August 28, 2018, alerts on this topic.

Qualified opportunity funds (QOFs) offer a unique opportunity for United States taxpayers who recognize gain in taxable transactions such as a business sale or a liquidity event in an investment fund. Investors may defer tax on gains, and even avoid some of those taxes, by timely making an investment in one of these new vehicles.

This alert summarizes the potential tax benefits of investing gains in QOFs under Section 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "Code") and final regulations released on December 19, 2019 (the "Final Regulations"), which adopted in part and revised in part two rounds of proposed regulations (the "Proposed Regulations"). Although some unresolved issues remain, the Final Regulations provide helpful guidance to taxpayers seeking to invest in QOFs.

Compared with the Proposed Regulations, the Final Regulations provide some key taxpayer-friendly revisions. In summarizing the program below, we highlight notable provisions where the Final Regulations diverge from the prior guidance under the Proposed Regulations.

What is the purpose of Code Section 1400Z-2 and the QOZ program?

Qualified opportunity zones ("QOZs") are intended to spur economic development and to create jobs in distressed communities by incentivizing investment in such communities. As described further below, investors in QOFs (which in turn invest in QOZs) can defer taxable gain recognition and, in some cases, exclude portions of such gains from taxes altogether.

What is a QOZ?

A QOZ is a population census tract in a low-income community that is formally designated by the Treasury Department as a QOZ. A list of approved QOZs can be found here.

What type of income or gain can be deferred by investment in a QOZ?

If a taxpayer engages in a taxable sale or exchange with an unrelated person before 2027, the taxpayer may defer any gain arising from that sale or exchange by making an equity investment in a QOF. The investment in the QOF must take the form of equity – e.g., a partnership interest or common or preferred stock – rather than debt. The property sold or exchanged can be any type of property (e.g., real estate, stock, art, bitcoin), but only capital gains and certain Section 1231 gains are eligible for deferral. The taxpayer must invest in a QOF (in an amount equal to the desired amount of gain deferral) during the 180-day period beginning on the date the property is sold or exchanged. (We discuss the calculation of the 180-day period below.) The taxpayer may make its investment in the QOF by contributing either cash or, subject to special rules for determining the amount and basis of a qualifying investment, other property. Alternatively, a taxpayer can acquire an eligible interest in a QOF from a person other than the QOF.

Once an election is made to defer some or all of the gain from a sale or exchange (such elected amount, the "Deferred Gain"), the taxpayer cannot receive benefits for multiple QOF investments for the same Deferred Gain. However, if a taxpayer recognizes gain (e.g., $100) and elects to defer only a portion of the gain (e.g., $30 of the $100), the taxpayer can still elect to defer the remaining gain (any or all of the remaining $70) as long as the taxpayer satisfies the original 180-day investment period requirement.

Can a taxpayer reinvest return from a QOF into another QOF?

Yes. The Proposed Regulations provided that if a taxpayer disposed of the entire QOF interest investment with respect to a Deferred Gain, the taxpayer could make another QOF investment and effectively "re-defer" the Deferred Gain. In a taxpayer-friendly revision of the Proposed Regulations, the Final Regulations provide that even if a taxpayer disposes of less than its entire investment in a QOF, the resulting gain can be eligible for re-deferral. The 180-day reinvestment period begins on the date the QOF investment is disposed of (rather than the date of the original sale or exchange that gave rise to the eligible gain to which the inclusion event relates). Notably, the taxpayer's holding period in the new QOF investment for purposes of the basis step-up and 10-year benefits (both such benefits discussed below) begins on the date of the reinvestment into the new QOF.

Who is the "taxpayer" eligible to defer gain?

The "taxpayer" eligible to defer gain is "a person that may recognize gains" for tax purposes. Thus, individuals, C corporations (including regulated investment companies and real estate investment trusts), partnerships, and certain other pass-through entities all may enjoy tax benefits associated with QOF investments. If a partnership, S corporation, or other pass-through entity recognizes gain eligible for deferral and passes that gain through to its owner(s), the owner(s) instead of the entity may elect to defer gain by making a QOF investment.

How is the 180-day investment period calculated in the partnership context?

The 180-day period begins on the day on which the gain would be recognized for federal income tax purposes absent a QOF deferral election. The partnership itself may elect to defer some or all of an eligible gain. To the extent a partnership opts not to defer eligible gains, any partner of that partnership may elect to defer some or all of such eligible gains included in that partner's distributive share as long as the partner makes a QOF investment during the 180-day period beginning on the last day of the partnership taxable year in which the partner's allocable share of the partnership's (undeferred) eligible gain is taken into account. The partners of a partnership, however, can elect to treat their 180-day investment period as the same period as the partnership's. The Final Regulations provide another inclusion election for partners of a partnership, allowing the partners to defer the start of their 180-day investment period until the due date of the partnership return (without extensions) on which such gains are reported.

For example, assume ABC Partnership realizes a capital gain on January 17, 2019, and does not make a QOF investment. The 180-day investment period for each partner of ABC Partnership with respect to that partner's portion of the eligible gain begins on December 31, 2019, if ABC Partnership uses the calendar year. However, one or more of ABC's partners can opt to start the 180-day investment period on either January 17, 2019 (if, for example, a desirable QOF investment opportunity arises during the first six months of 2019) or on March 15, 2020 (the unextended due date for ABC Partnership's 2019 Form 1065).

How is the 180-day investment period calculated for other flow-through entities (S corporations, trusts, estates)?

The same basic principles as outlined above in the case of partnerships and their partners apply to S corporations, nongrantor trusts, and decedent's estates and their beneficial owners, to the extent a beneficial owner receives or is deemed to receive an allocable share of the eligible gain.

Grantor trusts generally are disregarded for U.S. federal income tax purposes. Consistent with this concept, the Final Regulations clarify that if a grantor trust recognizes gain eligible for deferral, either the grantor trust or the deemed owner (grantor) of the trust can make the deferral election and a qualifying investment of the gain, relying on the same principles as outlined above in the case of partnerships and their partners, regardless of whether the gain is distributed to the deemed owner of the trust.

When does the 180-day investment period begin in the case of an installment sale?

The Proposed Regulations did not address the applicable 180-day investment period in the case of an installment sale. The Final Regulations directly address installment sales, providing that a taxpayer can elect either (1) to treat the last day of the taxable year in which the taxpayer would have recognized the gain under the installment method (if the gain were not deferred under the QOZ rules) as the beginning of the 180-day period or (2) to defer gains as they are received during the taxable year. If the taxpayer elects to defer gains as they are received, the date of each payment of a relevant installment begins the 180-day investment period for that installment. Those rules apply even to installment sales that occurred before 2018, when QOZ deferral became effective.

What if a taxpayer's gain is from the sale of a Section 1231 property (e.g., depreciable property and real property used in a trade or business)?

The Proposed Regulations had provided that only net Section 1231 gain (i.e., Section 1231 gains reduced by Section 1231 losses for the taxable year) was eligible for reinvestment. The Final Regulations have modified the Proposed Regulations, instead providing that gross Section 1231 gain (i.e., gain from the sale of a Section 1231 asset, reduced only by depreciation recapture) is eligible for deferral.

Because the formulation of eligible Section 1231 gain in the Proposed Regulations was dependent on the netting concept, the 180-day deferral period could not start until the end of the taxable year in which a Section 1231 asset was sold with respect to any resulting Section 1231 gain. Because the Final Regulations allow for the deferral of gross Section 1231 gain, the 180-day deferral period for such gain in the Final Regulations now starts on the actual sale of property giving rise to the Section 1231 gain.

May a taxpayer invest more than the amount of Deferred Gain in a QOF?

Yes. If an investor makes an investment in a QOF and only a portion of such investment constitutes Deferred Gain, then the investment is treated as two separate investments: one that includes only Deferred Gain, and another that does not represent Deferred Gain. The rules of Code Section 1400Z-2 apply only to the Deferred Gain portion of the investment in the QOF. Special rules apply to determine the portion of investments into partnerships that are treated as investments of Deferred Gain.

How does a taxpayer notify the IRS that it is deferring gain by investing in a QOF?

Taxpayers make deferral elections on Form 8949 (Sales and Other Dispositions of Capital Assets). Taxpayers are instructed to file the deferral election forms with their federal income tax returns for the year in which the tax on the deferred gain would be due but for the QOF investment.

When is Deferred Gain recognized?

Deferred Gain is included in the taxpayer's income when the "investment" is sold, exchanged, or otherwise reduced or terminated (an "Inclusion Event") or, if earlier, December 31, 2026. Accordingly, if the taxpayer does not dispose of its QOF investment in a taxable transaction before December 31, 2026, the taxpayer generally must recognize Deferred Gain on December 31, 2026. If the QOF investment continues to appreciate, the taxpayer will recognize additional gain on a subsequent taxable sale or exchange.

When is the Deferred Gain inclusion calculated?

In general, a QOF investor must include Deferred Gain when the QOF investor's direct or indirect qualifying investment is reduced, "cashed out," or otherwise terminated. For example, a transfer by a partner of a partnership interest in a QOF can be an Inclusion Event, as can a gift, a transfer pursuant to a divorce, or a charitable donation of the investment.

Deferred Gain is triggered when an investor into a QOF partnership receives a distribution of property having a value exceeding the QOF investor's basis in the QOF partnership interest. Notably, when Deferred Gain is invested in a QOF partnership, the investor's initial basis in his or her interest is $0. Thus, early distributions can easily trigger gain inclusion.

How is the Deferred Gain inclusion calculated?

The gain's tax attributes are preserved and taken into account when the Deferred Gain is included, but at the tax rates in effect for the year of inclusion. For example, assume a taxpayer realizes short-term capital gain in 2019 as a result of selling property held for only six months, invests the Deferred Gain amount in a QOF, and disposes of the QOF investment in 2025. In this example, the Deferred Gain, when recognized, will be taxed at the short-term capital gains rates in effect in 2025 (not 2019).

How much of the Deferred Gain is recognized on an Inclusion Event or on December 31, 2026?

When there is an Inclusion Event or, if earlier, on December 31, 2026, the taxpayer generally must include in income an amount equal to the excess (taking into account, in the case of partial dispositions, only the portion of the investment disposed of and the associated Deferred Gain and tax basis) of:

(A) The lesser of

i. the Deferred Gain and

ii. the fair market value of the investment;

over

(B) The taxpayer's basis in the investment ("Investment Basis").

Special rules govern partnership and S corporation investments as well as inclusion events arising from the distribution of property by a QOF.

Initially, the taxpayer's Investment Basis is zero. However, if the investment is held for at least five

years, the Investment Basis is increased by an amount equal to 10% of the Deferred Gain. If the investment is held for at least seven years, the Investment Basis is increased by another 5% of the Deferred Gain (i.e., a total basis increase of 15% of the Deferred Gain). Notably, any investments of Deferred Gain made after December 31, 2019, cannot benefit from the 15% basis step-up resulting from a seven-year holding period, as it is not possible to hold a QOF investment for at least seven years prior to December 31, 2026, for any investment made in 2020 or in any later years. However, a taxpayer can permanently exclude a portion of the Deferred Gain from taxation by holding the QOF investment for at least five years if the investment is made before 2022.

If the investment is held on December 31, 2026, the taxpayer then must include in income an amount equal to the Deferred Gain, net of the basis adjustments discussed above. Going forward, the recognized gain amount is added to the taxpayer's new basis in the investment.

A special gain exclusion rule applies where a taxpayer holds their investment in the QOF for at least 10 years. In such case, when the taxpayer disposes of their investment in the QOF, the taxpayer can elect for the basis of the investment to equal the fair market value of the investment on the date of the Inclusion Event. This rule allows the taxpayer to exclude all appreciation in an investment (above the Deferred Gain, which must be recognized no later than 2026) if the investment is held for at least 10 years. If the investment has decreased in value, the taxpayer can choose to not elect into this regime, thus avoiding a basis "step-down" and recognizing the loss inherent in the investment.

In a taxpayer-favorable revision to the Proposed Regulations, the Final Regulations provide that if the taxpayer holds a qualifying investment in a QOF partnership or a QOF S corporation, the 10-year benefits can be realized not only when a taxpayer sells its qualifying interest in the QOF but also when the QOF disposes of QOZ property (such as equity in a QOZ business entity) or where a QOZ business disposes of its assets after the 10-year holding period for the investment in the QOF has been satisfied. However, this favorable gain exclusion rule does not apply to sales of inventory in the ordinary course of business (such that the sale of QOF equity may still result in more favorable tax consequences in an exit transaction).

Notably, the special 10-year rule applies only with respect to Deferred Gain invested in a QOF.

Consider the following illustrations of the above rules:

On August 1, 2018, InvestCo sells its shares of Corp A stock for $5,000,000. InvestCo purchased the Corp A shares in 2015 for $1,000,000. InvestCo should have a gain recognition event in 2018 of $4,000,000 ($5,000,000 amount realized minus $1,000,000 basis).

InvestCo can defer the recognition of all $4,000,000 of gain in 2018 if it elects to invest $4,000,000 in a QOF by January 28, 2019 (180 days after August 1, 2018). For purposes of the following alternatives, assume that InvestCo invests all $4,000,000 in Fund A, a QOF, on September 1, 2018.

<u>Alternative 1</u>: InvestCo sells its interest in Fund A on December 1, 2021, when its Fund A interest is worth $5,000,000. InvestCo recognizes $5,000,000 of gain in 2021, consisting of the $4,000,000 of Deferred Gain (Investment Basis is $0) and the $1,000,000 of appreciation in the Fund A interest's value during InvestCo's holding period.

<u>Alternative 2</u>: InvestCo sells its interest in Fund A on December 1, 2023, when its Fund A interest is worth $5,000,000. InvestCo recognizes $4,600,000 of gain in 2023, consisting of $3,600,000 of Deferred Gain and the $1,000,000 of appreciation in the Fund A interest's value during InvestCo's holding period. Since InvestCo held its interest in Fund A for five years, its Investment Basis increases from $0 to $400,000 (10% of the $4,000,000 Deferred Gain). Accordingly, InvestCo only recognizes $3,600,000 of the Deferred Gain, permanently avoiding tax on the remaining $400,000.

<u>Alternative 3</u>: InvestCo sells its interest in Fund A on December 1, 2025, when its Fund A interest is worth $5,000,000. InvestCo recognizes $4,400,000 of gain in 2025, consisting of $3,400,000 of Deferred Gain and the $1,000,000 of appreciation in the Fund A interest's value during InvestCo's holding period. Since InvestCo held its interest in Fund A for seven years, its Investment Basis increases from $0 to $600,000 (15% of the Deferred Gain). InvestCo only recognizes $3,400,000 of the Deferred Gain, permanently avoiding tax on the remaining $600,000.

<u>Alternative 4</u>: InvestCo sells its interest in Fund A on December 1, 2027, when its Fund A interest is worth $5,000,000. In 2026, InvestCo will recognize $3,400,000, representing the original $4,000,000 Deferred Gain minus the $600,000 (15%) Investment Basis increase achieved by holding the Fund A investment for at least seven years. InvestCo's Investment Basis in its Fund A interest consequently increases from $600,000

to $4,000,000. In 2027, InvestCo will recognize an additional $1,000,000 of gain–i.e., the $5,000,000 sale proceeds minus its $4,000,000 post-2026 basis.

Alternative 5: InvestCo sells its interest in Fund A on December 1, 2028, when its Fund A interest is worth $5,000,000. As in Alternative 4, InvestCo will recognize $3,400,000 of Deferred Gain in 2026. However, if InvestCo elects into the special gain-exclusion regime for taxpayers who have held their interest in a QOF for at least 10 years, the basis of the Fund A interest will increase to its fair market value–$5,000,000–so InvestCo will not recognize any additional gain in 2028 upon sale of its interest in Fund A.

Alternative 6: Fund A sells all of its QOZ property on December 1, 2028, resulting in an allocation of $1,000,000 of gain to InvestCo ($5,000,000 sale proceeds less $4,000,000 basis). As in Alternative 4, InvestCo will recognize $3,400,000 of Deferred Gain in 2026. However, if InvestCo elects into the special gain-exclusion regime for taxpayers who have held their interest in a QOF for at least 10 years, InvestCo can exclude from gross income the $1,000,000 of gain arising from the disposition of the QOZ property and reported on InvestCo's Schedule K-1 (so long as such gain is not attributable to the sale of certain inventory items).

What is a QOF?

A QOF is an entity that is classified as a corporation or partnership that satisfies two requirements. Notably, a limited liability company classified as either a corporation or partnership can be a QOF.

First, the corporation or partnership must be organized for the purpose of investing in QOZ property (other than another QOF), although a pre-existing entity may qualify as a QOF.

Second, at least 90% of the assets of the corporation or partnership must be "QOZ property." The 90% QOZ property test is based on the average of the percentage of QOZ property held in the QOF, measured on the last day of the first six-month period of the QOF's taxable year and on the last day of the QOF's taxable year. For purposes of the 90% test, the QOF may elect to disregard investments received in the preceding six months and held in cash, cash equivalents, or debt instruments with a term of 18 months or less. If a QOF was formed in September 2019, the end of the first testing period would be on December 31, 2019 for a calendar-year entity. A QOF must pay a penalty for each month that it fails to meet the 90% requirement unless the QOF can show reasonable cause for such failure.

What is QOZ property?

"QOZ property" includes: (i) QOZ stock, (ii) QOZ partnership interests, and (iii) QOZ business property. QOZ property must meet the following requirements:

1. Acquisition Specifications. QOZ stock or QOZ partnership interests must be acquired from the issuing entity for cash after December 31, 2017. Notably, redemptions of the QOZ stock may cause the QOZ stock to lose its qualifying status. QOZ business property must be acquired in a taxable purchase after December 31, 2017; such property cannot be acquired from a related person or entity. Some examples of disqualifying relationships include: a partnership and a person owning, directly or indirectly, more than 20% of the capital or profits of such partnership; partnerships in which the same person owns, directly or indirectly, 20% of the capital or profits of such partnerships; and an individual and his or her spouse, ancestors, and lineal descendants. If the QOF leases QOZ business property, it must do so on market terms under one or more leases entered into after December 31, 2017. Additional requirements apply where the lessor is a related person. The Final Regulations provide that QOZ business property can be manufactured, constructed, or produced by the QOF (or QOZ business entity, as relevant) if it was manufactured, constructed, or produced beginning after December 31, 2017 for use by the eligible entity with the intent to use the property in a trade or business in a QOZ, and the relevant materials are QOZ business property.

2. Holding Period Specifications. During at least 90% of the QOF's holding period for any stock or partnership interest, such corporation or partnership, as applicable, must qualify as a QOZ business. During at least 90% of the QOF's holding period for any QOZ business property, a minimum of 70% of the QOZ's property must be used within a QOZ. Special rules apply for certain property utilized in rendering services inside and outside of a QOZ, property in transit, and property straddling a QOZ.

3. Use Specifications. At the time any QOZ stock or QOZ partnership interest is acquired, the entity (corporation or partnership) must be a "QOZ business" (defined below)–or, if a new entity, it must be organized for purposes of being a QOZ business. The "original use" of any QOZ business property in the QOZ must commence with the QOF, or the QOF must "substantially improve" the QOZ business property.

The "original use" of tangible property in a QOZ begins on the date any person first places the property in service in the QOZ for purposes of depreciation or amortization (or first uses that property in a manner that would allow depreciation or amortization if that person were the property's owner). The Final Regulations provide a helpful example, illustrating that a newly constructed building purchased from a developer can be treated as original use property as long as the QOF completes the building and places it in service. Also, the Final Regulations shorten the vacancy period in the Proposed Regulations. If real property has been vacant (defined as more than 80% of the building or land not being used, measured by square footage of usable space) for an uninterrupted three calendar year period (or less, if the property was vacant before the QOZ regime was enacted), then the Final Regulations clarify that the property's original use commences on the date any person first uses or places the property in service in a QOZ after the vacancy period. Similarly, tangible property that previously has been used outside a QOZ may satisfy the "original use" test in a QOZ. However, tangible property that has been used or placed in service in a QOZ before its acquisition by purchase must be "substantially improved" as it cannot re-qualify for "original use" in the QOZ. The Final Regulations adopted special rules for land that is a brownfield site (generally providing the property qualifies as original use property if the eligible entity adequately invests in the clean-up of the property) and real property purchased from a local government that has been held as a result of an involuntary transfer (which is now deemed to satisfy the original use requirement in the hands of the eligible entity).

Property is deemed "substantially improved" by the QOF only if, during any 30-month period beginning after the date the QOF acquires the property, the QOF makes improvements to the property that exceed in value the property's original value as of the QOF's acquisition date. If a QOF purchases a building that is located on land wholly within a QOZ, "substantial improvement" is measured by the additions to the adjusted basis of the building and does not require a separate improvement of the land upon which the building is located. Unimproved land that is located in a QOZ and acquired by purchase need not be "substantially improved" – i.e., such land is deemed to satisfy the "original use" test; however, the purchaser of such unimproved land must have an expectation or intention to improve the land by more than an insubstantial amount within 30 months of its purchase. Otherwise, that special exclusion does not apply and the land must satisfy the substantial improvement requirement.

The Final Regulations include special aggregation rules for determining whether tangible property has been substantially improved, allowing the basis required to be added to the eligible building group, as a group, to equal the total amount of basis of the buildings in the group and the additions made to all such buildings. All buildings located entirely within the geographic borders of a parcel of land described in a single deed can be treated as an eligible building group. Additionally, multiple buildings described in separate deeds and located entirely within the geographic borders of contiguous parcels of land can be treated as an eligible building group if those buildings share facilities or significant centralized business elements, are operated exclusively by the eligible entity, and are operated in coordination with or in reliance upon one or more of the trades or businesses.

A "QOZ business" is a trade or business that satisfies three requirements.

First, at least 50% of the total gross income of the business must be derived from the active conduct of such business in a QOZ; at least 40% of the business' intangible property must be used in the active conduct of the business in that QOZ; and less than 5% of the average of the aggregate unadjusted bases of the business' property must be attributable to nonqualified financial property (e.g., debt, stock, partnership interests, options, futures, forwards, warrants, swaps, etc.).

"Nonqualified financial property" does not include "reasonable amounts" of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less ("Working Capital Assets"). The Final Regulations retained the working capital safe harbor ("Working Capital Safe Harbor") established in the Proposed Regulations: Working Capital Assets will be treated as held in "reasonable amounts" if (i) the Working Capital Assets are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ or the development of a trade or business in the QOZ; (ii) there is a written spending schedule that is consistent with the ordinary start-up of a trade or business; (iii) the Working Capital Assets are spent within 31 months of the receipt by the business of such assets (an exception is allowed for governmental delays, as long as an application for government action is completed during the 31-month period); and (iv) the assets are actually used in a manner consistent with the written designation and the spending schedule. A QOZ business may benefit from

multiple overlapping or sequential applications of the Working Capital Safe Harbor. In a change from the Proposed Regulations, the Final Regulations make clear that tangible property may benefit from an additional 31-month period, for a total of up to 62 months, in the form of overlapping or sequential Working Capital Safe Harbors. However, the Working Capital Assets covered by an application of the Working Capital Safe Harbor must be expended under the specific Working Capital Safe Harbor plan adopted for the contributed Working Capital Assets and subsequent infusions of Working Capital Assets must form an integral part of the plan covered by the initial Working Capital Safe Harbor period. Additionally, the overlapping or sequential Working Capital Safe Harbor must include a substantial amount of Working Capital Assets.

In calculating whether 50% of the total gross income of the business is derived from the active conduct of a business in a QOZ, gross income derived from reasonable amounts of Working Capital Assets (i.e. Working Capital Assets covered by the Working Capital Safe Harbor) will be treated as income counted toward satisfaction of the 50% test. While reasonable amounts of Working Capital Assets are being expended on property, such property will not fail to be treated as QOZ business property during that and subsequent Working Capital Safe Harbor periods, as long as it is expected that the property will satisfy the requirements of QOZ business property as a result of those expenditures.

Second, the following types of businesses cannot qualify as QOZ businesses, nor can businesses leasing more than a de minimis (less than 5% based on net rentable square feet or value, as applicable) amount of property to the following trades or businesses: 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. De minimis (less than 5% based on gross income) amounts of gross income attributable to such "sin" businesses will not cause a trade or business to fail to be a QOZ business.

Third, 70% of the tangible property owned or leased by the taxpayer must be "QOZ business property" – i.e., tangible (real or personal) property that meets the Acquisition Specifications, Holding Period Specifications, and Use Specifications outlined above (determined by substituting "QOZ business" for "QOF" where it appears above). The Final Regulations provide that in determining whether this 70% tangible property test is met, a QOZ business can choose to exclude all inventory from both the numerator and denominator of the applicable formula.

The Final Regulations allow a one-time cure period where a business fails to qualify as a QOZ business (thereby causing its equity to fail to be treated as QOZ property). A QOF may treat the stock or partnership interest in the business as QOZ property for the relevant semiannual testing date as long as the business corrects the failure within 6 months of the date on which the business failed to be treated as a QOZ business.

What does it mean for income to be derived from the active conduct of a business in a QOZ?

The Final Regulations (adopting the Proposed Regulations) provide three safe harbors and a facts and circumstances test for determining whether 50% of the total gross income of a business is derived from the active conduct of such business in a QOZ:

1. Safe Harbor #1: At least 50% of the services performed (based on hours) for the business by its employees, independent contractors (and employees of independent contractors), and certain partners of a partnership are performed within the QOZ.
    - This safe harbor is helpful for a software-based tech business that is headquartered in a QOZ but sells applications globally through the internet.
2. Safe Harbor #2: Based on amounts paid for the services performed, at least 50% of the services performed for the business by its employees, independent contractors (and employees of independent contractors), and certain partners of a partnership are performed in the QOZ.
    - This safe harbor is helpful for a business that maintains a satellite office outside of a QOZ but pays 50% or more of its total compensation for services to the employees in a QOZ-based office.
3. Safe Harbor #3: The tangible property located and management or operational functions performed in the QOZ are each necessary for the generation of at least 50% of the gross income of the trade or business.
    - This safe harbor is helpful for a landscaping or similar business, where the headquarters and personnel managing the daily operations are in the QOZ, as is the storage of its equipment and supplies.
4. Facts & Circumstances Test: Based on the facts and circumstances, at least 50% of the

gross income of a trade or business is derived from the active conduct of a trade or business in a QOZ.

For purposes of the QOZ regime, "active conduct of a trade or business" is defined by cross-references to the well-established body of law governing "above-the-line" trade or business expense deductions. Notably, the ownership and operation (including leasing) of real property used in a trade or business is deemed the active conduct of a trade or business for purposes of these rules as long as the taxpayer does not merely enter into a triple-net-lease (which is not defined for purposes of the QOZ regime) of real property owned by the taxpayer. The Final Regulations provide examples illustrating that triple-net-leased real property can constitute an active trade or business if the lessor conducts meaningful managerial and/or operational duties with respect to the real property.

Can a QOF reinvest return of capital to maintain its QOF status?

Yes. Proceeds received by the QOF from the sale or disposition of QOZ property are treated as QOZ property if (1) the QOF reinvests the proceeds in QOZ property during the 12-month period beginning on the date of the sale or disposition by the QOF of such QOZ property (subject to certain exceptions for government delay) and (2) at all times before the reinvestment, the proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less. However, any gain recognized on the sale or disposition of QOZ property is allocated under the normal partnership tax rules, resulting in income to the partners of a QOF partnership.

How does a partnership or corporation notify the IRS that it qualifies as a QOF?

An eligible partnership or corporation must self-certify as to its status as a QOF by completing and attaching a Form 8996 (Qualified Opportunity Fund) to the QOF's federal income tax return for the taxable year. The Form 8996 can be found here: https://www.irs.gov/pub/irs-pdf/f8996.pdf. Instructions for that form can be found here: https://www.irs.gov/pub/irs-pdf/i8996.pdf.

Are there still unanswered questions?

Yes. Although the Final Regulations are helpful in clarifying certain areas of uncertainty, there are still some unanswered questions and areas of ambiguity. Additionally, there is a broad anti-abuse rule in the Final Regulations providing that if a significant purpose of a transaction is to achieve a federal income tax result that is inconsistent with the purposes of the QOZ rules, then that transaction may not enjoy QOZ benefits. In sum, the rules are complex and some uncertainty persists, accordingly, it remains essential to make QOF investments only after careful planning (including a thorough assessment of nontax legal and business risks) and discussions with tax counsel.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

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