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# The Qualified Opportunity Zone Program: Thoughts on the Long-Awaited Treasury Guidance

## Treasury takes an important first step in bringing clarity to the QOZ program.

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## TAKEAWAYS

- The Proposed Regulations provide a 31-month grace period for development of a QOZ Business
- The treatment of land is clarified for purposes of the Qualified Opportunity Zone Business Property rules
- The Proposed Regulations confirm that an investor's share of partnership debt under Code Section 752 is not treated as a separate investment in a Qualified Opportunity Fund

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Section 13823 of the Tax Cuts and Jobs Act, P.L. No. 115-97 (2017) added Sections 1400Z-1 and 1400Z-2 to the Internal Revenue Code of 1986, as amended (the "**Code**"). These provisions created the Qualified Opportunity Zone ("**QOZ**") program that has recently generated such a wave of media attention that one might surmise President Trump had sent an angry late-night tweet about it.

As laudable as the goals of the QOZ program might be, the statutory provisions enacted by Congress setting forth the program benefits and requirements were written in such haste that they suffer from a mix of poor drafting, incorrect and/or ambiguous cross references, and a general failure to think through a real-world implementation of the program. The lack of clarity caused the program to get off to a slow start as prospective program participants sat on the sidelines while Treasury assumed the unenviable task of crafting guidance that would hold true to the perceived intent of Congress (itself not always clear), fill in the gaps in the statutory language and outline a coherent program structure without crossing the line into becoming a substitute legislature. The first installment of that guidance was released on October 19, 2018 in the form of Proposed Regulations (the "**Proposed Regulations**") and accompanying Revenue Ruling 2018-29. While many questions remain unanswered, Treasury has taken an admirable first step in turning a Jackson Pollock painting into a portrait.

### BACKGROUND

Code Section 1400Z-1 outlined the criteria and process required to be followed by the governor of each State in designating various census tracts as "Qualified Opportunity Zones." In essence, the census tracts that could qualify for designation were those meeting the criteria for being characterized as economically distressed, along with a limited number of adjacent census tracts. A census tract designated as a QOZ retains that designation from the date of designation through the end of the calendar year in which the tenth anniversary of such designation occurs. That designation process was completed earlier this year.

Code Section 1400Z-2 contains the operational elements of the QOZ program, including (i) the federal income tax benefits of participating in the program (derived from the deferral and partial exemption of recognition of capital gains), (ii) the requirement of establishing a Qualified Opportunity Fund (a "**QOF**") as the investment vehicle for taxpayers participating in the program, (iii) the tests that must be satisfied by the QOF and penalties for noncompliance and (iv) the types of investments that are permissible for a QOF to make in a QOZ in order to qualify for the program benefits.

Detailed discussions of the essential elements of the program are widely available and, accordingly, this paper provides as brief an outline of the program as possible before delving into a discussion of certain of the key aspects of the new Treasury guidance. Unfortunately, a fair amount of detail is necessary to put the Proposed Regulations and Revenue Ruling into proper context, so the author admits that calling this a "brief outline" is an inaccurate description.

By way of illustration, if a taxpayer sells property to an unrelated person after December 31, 2017 and on or before December 31, 2026 and realizes capital gains as a result, the taxpayer may elect to defer recognition of all or a portion of such capital gain (the "**Deferred Gain**") by investing cash up to the amount of the Deferred Gain in a QOF during the 180-day period beginning on the date of such sale. (Unlike like-kind exchanges, there is no tracing concept, and the taxpayer is permitted to hold and invest the sale proceeds prior to its contribution to the QOF.) The Deferred Gain must be recognized in income as of the earlier of (i) the taxpayer's disposition of its interest in the QOF and (ii) December 31, 2026. If the taxpayer holds the QOF investment for a period of five years, the taxpayer may permanently exclude 10 percent of the Deferred Gain from income and, after an additional two years, an exclusion of a further 5 percent of the Deferred Gain is available. (Such exclusions are not available if the foregoing five- and/or seven-year periods would terminate after December 31, 2026.) If, as of December 31, 2026, or the earlier date of disposition of the QOF interest, the Deferred Gain (as reduced in accordance with the foregoing) exceeds the value of the QOF interest, the Deferred Gain required to be recognized is reduced by such excess.

If the taxpayer holds its QOF interest for more than 10 years, upon disposition it may elect to step up its basis in the QOF interest to fair market value, the intended result being to effectively exclude from income any gain realized on the sale of the interest. Because this basis adjustment is elective, if the value of the QOF interest has diminished, the taxpayer may skip the basis adjustment and recognize the loss on the disposition of the QOF interest.

A QOF is any investment vehicle organized as a partnership or a corporation for the purpose of investing in qualified opportunity zone property ("**QOZ Property**"), but specifically excluding an investment in another QOF. A minimum of 90 percent of the assets of a QOF must be QOZ Property, as measured as of the end of the sixth and twelfth month of each taxable year, with interest-like penalties imposed to the extent that the foregoing test (the "**90% Test**") is not satisfied. Such penalties are important to avoid, as they can quickly devour the benefits of deferred recognition of the Deferred Gain.

QOZ Property is defined as property that is qualified opportunity zone stock ("**QOZ Stock**"), a qualified opportunity zone partnership interest ("**QOZ Partnership Interest**") or qualified opportunity zone business property ("**QOZ Business Property**").

- QOZ Stock is stock in any domestic corporation if (i) the stock is acquired by the QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash, (ii) as of the date of issuance, such corporation is a qualified opportunity zone business ("**QOZ Business**") (or, in the case of a new corporation, it was organized for the purpose of becoming a QOZ Business) and (iii) for substantially the entire period the QOZ Stock is held by the QOF, the corporation is a QOZ Business (such a corporation being a "**QOZ Corporation**").

- A QOZ Partnership Interest is any capital or profits interest in a domestic partnership if (i) the interest is acquired by the QOF after December 31, 2017 directly from the partnership solely for cash, (ii) as of the date of issuance, such partnership is a QOZ Business (or, in the case of a new partnership, it was organized for the purpose of becoming a QOZ Business) and (iii) for substantially the entire period the QOZ Partnership Interest is held by the QOF, the partnership qualifies as a QOZ Business (such a partnership being a "**QOZ Partnership**").
- QOZ Business Property is tangible property used in the trade or business of the QOF (or, as applicable, a QOZ Corporation or a QOZ Partnership) if (i) such property was acquired by purchase (within the meaning of Code Section 179(d)(2) after December 31, 2017, but substituting a 20 percent related party test for the otherwise applicable 50 percent test), (ii) original use commences with the QOF, or the QOF substantially improves the property and (iii) for substantially the entire period the QOF owns the property, such property was used in a QOZ. Property is treated as substantially improved if, during the 30-month period beginning after the acquisition of the property, additions to basis of such property in the hands of the QOF exceed its adjusted basis as of the start of such 30-month period. (The statute actually says "any" 30-month period following acquisition for purposes of the substantial improvement rule, but there is some suggestion that Treasury believes the clock starts running upon acquisition, which makes sense.)

A QOZ Business is a trade or business (i) in which substantially all of the tangible property owned or leased by the business is QOZ Business Property (the "**Substantially All Test**"), (ii) which satisfies the requirements of Code Section 1397C(b)(2), (4) and (8) (i.e., at least 50 percent of the gross income must be derived from the active conduct of the trade or business (the "**Gross Income Test**"), a substantial portion of the intangible property of the business must be used in the active conduct of such business and less than five percent of the aggregate unadjusted bases of the business's assets may constitute nonqualified financial property) and (iii) is not described in Code Section 144(c)(6)(B) (i.e., golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or liquor store).

It should be noted that while Code Sections 1400Z-2(d)(2)(B) and (C) expressly reference the conduct of a QOZ Business, Code Section 1400Z-2(d)(2)(D) does not. Thus, read literally, if a QOF acquires QOZ Business Property and operates a trade or business directly in lieu of acquiring QOZ Stock and/or QOZ Partnership Interests, the QOF would not have to satisfy the requirements applicable to a QOZ Business. However, there is no suggestion in the legislative history that this result was intended by Congress, and is likely the result of inadvertent drafting. Accordingly, unless one enjoys the excitement of sparring with the Internal Revenue Service, I would not recommend structuring QOF investments on this basis.

If the equity invested in a QOF is a mix of capital gains meeting the requirements for being Deferred Gains along with other funds, Code Section 1400Z-2(e) treats the investment as two separate investments even if made by the same taxpayer, and the benefits of the QOF program only apply to Deferred Gains.

As the foregoing suggests, the QOZ program can provide significant federal income tax benefits to investors in QOFs. This is precisely what Congress intended—to actively encourage taxpayers with appreciated investments to purposefully generate capital gains for investment in the QOZ program, thereby bringing private equity into distressed markets. An important caveat to bear in mind, though, is that while a program such as the low-income housing tax credit program provides federal income tax benefits as a substitute for non-tax economic profit, the QOZ program does not—it simply provides enhancements to yield for investments that might not otherwise fit an investor's risk profile through a reduction in the federal income tax cost of the investment. In other words, if an investment in a QOZ Business is a good investment, the QOZ program benefits will potentially enhance the yield on the investment. The benefits may also enhance an otherwise marginally attractive investment opportunity. As a general rule, though, the QOZ program will not turn a bad deal into a good one.

## PROPOSED REGULATIONS

The principal areas in which the Proposed Regulations provide guidance to taxpayers regarding the implementation of the QOF program are described below. In this regard, it should be noted that the emphasis of the discussion is on those areas of particular interest to the real estate industry (and, of course, to the author). Thus, for example, a discussion of the special rules in the Proposed Regulations dealing with Section 1256 contracts and straddles are outside the scope of this paper.

### Use of Limited Liability Companies

The statute states that a QOF must be "organized as a corporation or a partnership ..." (emphasis added). Similarly, the statute defines a QOZ Partnership Interest as "any capital or profits interest in a domestic partnership ...." The Proposed Regulations clarify in each case that the "partnership" in question is an entity classified as a partnership for federal income tax purposes (i.e., not necessarily an entity created as a partnership under applicable state law). Thus, an entity organized as a limited liability company under state law that is classified as a partnership for federal income tax purposes can be a QOF, and an interest in such an entity can constitute a QOZ Partnership Interest. This should have been an easy conclusion, but the unfortunate language employed by Congress makes this clarification by Treasury quite helpful.

### The 90% Test

Although the statute states that a QOF must satisfy the 90% Test to avoid the imposition of penalties, it does not specify how the 90% Test is determined. The Proposed Regulations address this by providing that if the QOF has an "applicable financial statement" as provided in Treasury Regulation Section 1.475(a)-4(h) (such as financial statements prepared for submission to the SEC or other federal agencies—excluding the Internal Revenue Service—or certified audited financial statements prepared in accordance with GAAP that are utilized for substantial non-tax purposes), the 90% Test is applied based upon the asset values set forth in such applicable financial statements. If the QOF does not have an applicable financial statement, the 90% Test is determined based upon the cost of each asset.

### The Substantially All Test

Code Section 1400Z-2(d)(3)(A) requires, in part, that to qualify as a QOZ Business "substantially all" of the tangible property owned or leased by the taxpayer must be QOZ Business Property. The statute does not, however, state what "substantially all" means. Happily, the Proposed Regulations clear this up by stating that "substantially all" means 70%.

The Proposed Regulations also specify how the Substantially All Test is determined. Specifically, it provides that if the entity has an "applicable financial statement" as described above, the Substantially All Test is applied based upon the asset values set forth in such applicable financial statements. If the taxpayer does not have an applicable financial statement, the Substantially All Test gets more complicated. The general rule is that, in this circumstance, the entity may use the same methodology as used by the QOF that owns the QOZ Stock/QOZ Partnership Interest for purposes of the 90% Test. (This is referred to as the Compliance Methodology.) However, if two or more QOFs hold more than 5% of the QOZ Stock (by vote and value if the entity is a QOZ Corporation) or more than 5% of the capital and profits interests (if the entity is a QOZ Partnership) (such QOFs referred to in the Proposed Regulations as Five Percent Zone Taxpayers), then the Substantially All Test is determined by using the Compliance Methodology of that Five Percent Zone Taxpayer producing the highest percentage of QOZ Business Property.

### Partnership-Related Issues

The statutory language raises, and does not attempt to resolve, enough partnership-related tax issues to, well, borrowing from John Lennon, fill the Albert Hall. Treasury addressed some of the most fundamental aspects of dealing with partnerships in the Proposed Regulations, and in part it did so with admirable flexibility, but to a large extent one is reminded of the robot in Lost in Space waving its arms while announcing "Danger! Danger!"

To address some of the key partnership-related items individually:

A. **Allocations of Partnership Debt under Code Section 752.** Code Section 752(a) states that an increase in a partner's share of partnership debt "shall be considered as a contribution of money by such partner to the partnership." Inconveniently, Code Section 1400Z-2(e)(1) states that if an investment in a QOF comprises partly Deferred Gains and partly other funds, the QOF interest is divided and only the former qualify for any of the QOZ program benefits. Yikes! Does this mean that if a QOF or a QOZ Partnership incurs indebtedness, the investor in the QOF must treat the leveraged portion of its investment as a separate investment for these purposes, such that only the equity portion of its investment qualifies for the QOZ program benefits? Happily, the Proposed Regulations expressly state that partnership indebtedness resulting in a deemed contribution to capital under Code Section 752(a) does not constitute a separate investment of non-qualifying funds that must be treated as a separate investment from the taxpayer's investment of capital gains. Excellent!

B. **However.** Let's assume a taxpayer invests $10 million of capital gains into a QOF, and the QOF invests the entire amount into a QOZ Partnership. The QOZ Partnership acquires land and builds a building that it operates in a QOZ Business by incurring construction/permanent indebtedness of $20 million. After more than 10 years, the project has increased in value and paid down debt such that the taxpayer's share of remaining QOZ Partnership debt is $15 million, and the fair market value of its QOZ interest (net of its share of debt) is $30 million. When the taxpayer sells its QOF interest for $30 million of cash, what is the result? I don't know. The right answer is that the taxpayer pockets the $30 million and goes home, but that may not be the correct answer. The problem is that Code Section 1400Z-2(c) allows the taxpayer to make an election to adjust its basis in its QOF interest to equal "the fair market value of such investment" as of the date the QOF interest is sold or exchanged. Is the fair market value of the QOF interest $30 million (i.e., the value net of the share of QOZ Partnership debt allocable to the QOF interest) or the gross fair market value of $45 million? The Proposed Regulations make clear that you do not have to bifurcate the gain between eligible and ineligible portions (meaning that because the equity was $10 million and the taxpayer's share of debt was $20 million, you are not required to treat only one-third of the gain as qualifying for the QOZ program benefits). However, if the election to increase basis only brings you to $30 million (net fair market value), the taxpayer is treated as having received $45 million in connection with the sale, with the result that its tax-free sale still results in recognition of $15 million of gain. That result is arguably consistent with the statutory language, but it is clearly inconsistent with Congressional intent. In describing the intended benefits of the QOZ program, the Conference Report states that "the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years." That seems pretty clear. Accordingly, while the statutory language can be read as suggesting that the basis step-up election after 10 years only limits gain to that portion of the deemed amount received on the sale of a QOF interest attributable to the taxpayer's allocable share of QOF indebtedness, there is significant merit to the proposition that Congress intended the entirety of such gain to be excluded from gross income, such that the proper reading of the statutory language is that the reference to "fair market value"[1] is properly interpreted as meaning "gross fair market value". Or, perhaps in plain English, it simply meant that, regardless, of the statutory mechanics, the intended result is that "the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years."

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[1] An argument in support of this could be drawn from the interaction between Code Sections 1014 and 742. In the event of the death of a partner, Treasury Regulation 1.742-1 makes clear that the fair market value basis step-up for the partnership interest in the hands of the person acquiring from the decedent includes the portion of partnership indebtedness allocable to that interest. This also keeps the treatment of a leveraged and unleveraged partnerships the same. Assume the above example except that the project is constructed without debt and the value of the investor's QOF interest over ten years appreciates to $45 million. The investor sells, the basis is stepped up to $45 million, so no gain is recognized. Now assume that, in year eight, $15 million of debt is placed on the property with the proceeds distributed to the investor. The $15 million is tax-free upon receipt. In year 10, the investor sells for $30 million, with $15 million of debt allocable to the QOF interest. If the basis step-up is limited to $30 million, the result is that the investor has received $45 million of cash, but must pay tax on $15 million of gain. That result does not make sense. If the basis step-up is to the gross fair market value of the investor's QOF Interest ($45 million), the net result is that the investor has received $45 million of cash and no gain recognition—the same result as if no debt had been placed on the property.

C. **Who Should Invest Gains Realized by a Partnership?** The Proposed Regulations very helpfully wade into the issues raised when the Deferred Gains are recognized by a partnership, although they only go ankle-deep into water that is seemingly bottomless.

1. As a starting point, the Proposed Regulations make clear that if a partnership realizes capital gains and decides not to invest the gains in a QOF, the partners may independently decide whether or not to invest their distributive shares of the capital gain in QOFs of their own choosing. This flexibility is very useful, although it is not unlimited. For example, assume a partnership has four members holding 25% each, and the partnership realizes a capital gain of $10 million. If the partnership decides to invest the full $10 million into a QOF, this would preclude any of the partners from investing separately in a QOF, which makes sense—a different result would potentially allow the aggregate investments of the partnership and the partners to exceed $10 million through the miracle of double-counting. Now, assume that the partnership invests $7.5 million of the gain in a QOF. The Proposed Regulations would permit the partners to individually invest their distributive shares of the remaining $2.5 million. However, the Proposed Regulations do not address whether the right to individually invest (or to not invest) the $2.5 million in its entirety could be specially assigned to one partner and, accordingly, specially allocate all the partnership-level QOZ program benefits to the remaining three partners. So what should the answer be? One can argue that this should be permissible, particularly if the partnership actually distributes the $2.5 million in cash to the one partner for the purpose of it making its own separate QOF investment (or non-investment). The position would be that the Treasury Regulations under Code Section 704(b) govern whether or not special allocations of partnership-level items will be respected as having substantial economic effect or as otherwise being in accordance with the partners' interests in the partnership. In this example, if the partnership in question specially allocates all items of income, gain, deduction and loss (and exclusion from income or gain) related to its investment of the $7.5 million in the QOF to the three partners, specially allocates the $2.5 million of gain and distributes the $2.5 million of sale proceeds to the remaining partner, and assuming this passes muster under Code Section 704(b), the argument would be that this answers the question in the absence of administrative guidance that expressly overrides Code Section 704(b) in this context.[2] While there is always discomfort in relying upon silence as authority—it would be wonderful if Treasury explicitly announced what it meant by its silence on the issue (which, I suppose, would no longer be silence)—I would also love my sons to feel that, when I speak to them, there might be something worth listening to. One simply can't have everything one desires.

2. A second point for consideration is whether it makes sense for a partnership that realizes capital gains to elect at the entity level to invest those gains directly in a QOF in lieu of simply allowing the partners to make their own decisions with respect to their distributive shares of the capital gain. Given the areas of uncertainty that would be encountered by a partnership making an entity-level investment in a QOF, such an election would not be for the faint of heart. For example, following our above illustration but assuming the partnership invests the full $10 million of capital gains in a QOF, what happens if partner A sells its interest in the partnership prior to December 31, 2026? That is clearly a taxable event to partner A, but what further implications are there? The Proposed Regulations are clear that, by investing the $10 million in the QOF, there has been no gain recognition, such that partner A's basis in the partnership will not have been increased by its 25% distributive share of that gain. Assuming the purchase price for partner A's interest reflects a 25% interest in the $10 million investment in the QOF, partner A is effectively taxed on its share of the deferred gain at that time. One would reach the same net result from a gain recognition perspective if

[2] There are clearly arguments to the contrary. For example, if a partnership enters into a like-kind exchange with boot, and that boot is used to cash out one partner that was not interested in participating in the exchange, the general sentiment seems to be that allocating all of the gain associated with the boot to the one partner, and allocating the deferred gain to the other partners, would not be respected. The QOZ program is distinguishable, though, in that the Proposed Regulations expressly contemplate that the benefits can be available to either the partnership, the partners, or a combination of the two.

Treasury were to treat partner A's sale as an event requiring actual recognition of partner A's distributive share of the deferred gain—the recognition of $2.5 million of deferred gain would be allocated to partner A, which would correspondingly increase partner A's basis in its partnership interest, yielding the same net gain on the sale from partner A's perspective. What are the consequences to the purchaser? If the sale does not result in an acceleration of partner A's share of the gain, one would hope that the purchaser of partner A's interest could make a Code Section 754 election to step up the basis of its share of the partnership's interest in the QOF. It is not entirely clear, however, that the election would work in this scenario. Code Section 1400Z-2(b)(2)(B)(i) states that the taxpayer's basis in its QOF interest is zero until it is increased by recognition of the deferred gain (subject to incremental basis increases for QOF interests held for five years and for seven years, respectively, prior to December 31, 2026). Would a Code Section 754 election override this zero-basis rule? This is not a circumstance (unlike in the previous paragraph) where an answer can be sussed out from Treasury's silence—we have potentially conflicting statutory provisions, and Treasury is the referee. (This also assumes that a successful Code Section 754 election would give partner A's transferee basis in the Deferred Gain, such that there would be no actual gain recognition by the transferee on December 31, 2026.) The situation is less troublesome if Treasury were to treat the disposition of partner A's interest as an event that accelerates its allocable share of the Deferred Gain. In this scenario, the recognition of $2.5 million of Deferred Gain by partner A gives the partnership a basis in the QOF of $2.5 million with respect to partner A's interest without the need of a Code Section 754 election. Based on the above discussion, the second scenario—treating partner A's disposition as a recognition event for the Deferred Gain—seems to be the more logical result, and one that avoids the Code Section 754 conflict with the QOZ basis rule. Unfortunately, that isn't necessarily the key to determining which scenario should prevail—it is really a policy decision by Treasury (unless Congress decides to help by amending the statute with clear and insightful revisions—ha!—just seeing if you were still awake) that impacts what happens after the transfer of partner A's interest. In other words, does partner A's transferee get to step into partner A's shoes with respect to the exclusion from gain for dispositions of a QOF interest that is held for more than 10 years? The policy decision to be made is whether the QOZ program is applied to the partnership as the entity that invested in the QOF, or is the intent behind the enactment of the QOZ program better served by looking through the partnership and applying its provisions individually with respect to each partner's interest? If we follow the partnership as an entity approach, logic would suggest that (i) the sale of the partnership interest by partner A does not accelerate its allocable share of the Deferred Gain, (ii) we (meaning Treasury) need to resolve the basis conflict issue of whether a Code Section 754 election can be successfully utilized by partner A's transferee and (iii) if the partnership holds its interest in the QOF for more than 10 years, upon disposition the partnership should be able to exclude the entire amount of any gain from income, benefitting all partners (including partner A's transferee). Alternatively, if we follow a look-through approach and apply the QOZ rules to the individual partners, the presumed consequences would be that (a) partner A's share of the Deferred Gain would be recognized in connection with the transfer, (b) the partnership would have a basis in the QOF with respect to transferee of partner A's interest that reflects the recognition of partner A's share of the Deferred Gain and (c) upon a sale of the QOF interest by the partnership after a minimum 10-year holding period, the election to exclude gain from the sale would only apply to the share of the gain allocable to the remaining three partners, and the transferee of partner A's interest would be fully taxable on any gain attributable to its share. It is anyone's guess which direction Treasury will take on this issue, and there isn't a single "right" answer. From my perspective, the look-through approach seems to be the preferable approach, as it appears to be less amenable to abuse and to most closely adhere to the ultimate economics of the investors. In the meantime, how does one deal with this level of uncertainty in structuring an investment in a QOF with respect to gains realized by a partnership? The simple answer seems to be to avoid it by having the partnership elect to not invest in a QOF, and allow the partners to decide whether or not to invest in a QOF on an individual basis. It is likely that, as the QOZ industry develops, there will be no shortage of QOF investment opportunities for those looking to defer capital gain recognition.

3. A third point for consideration is timing. If a partnership disposes of an asset that results in a realization of capital gains, it has 180 days from the date of the disposition to invest the capital gains in a QOF to qualify for the benefits of the QOZ program. If the partnership decides not to invest the gains in a QOF, the 180-day clock does not start running for the partners until the last day of the partnership's taxable year (although the partners do have the option to have the 180-day period commence with the date of the disposition by the partnership giving rise to the capital gains). This is such a helpful allowance for partners, reflecting an understanding of the difficulties that could otherwise be faced by partners in a partnership that realizes capital gains, that I feel like I should buy Treasury a cocktail. (I note that, similarly, in circumstances in which a RIC or a REIT realizes a capital gain, the RIC or REIT shareholder's (as applicable) 180-day period does not commence until the associated capital gain dividend is paid and, if the capital gain is undistributed, the 180-day period does not commence until the last day of the RIC's or REIT's (not intending a Halloween pun) taxable year.) In addition to addressing these difficulties, this rule has two other timing benefits. First, the QOF has very little time from when it receives a taxpayer's Deferred Gains to the date it must invest those Gains in QOZ Property to satisfy the 90% Test. If the QOF invests in a QOZ Partnership, the QOZ Partnership has a limited period of time to invest those Gains and have its QOZ Business operating. For investors receiving their capital gains through a partnership, the delay in commencement of the 180-day investment period gives them additional time to explore QOZ Business investment opportunities. Second, to the extent that uncertainties continue to exist in implementation of the QOZ program, this rule potentially provides such investors with additional time to wait for further guidance from Treasury.

In sum, it is not difficult to think of scenarios under which it may be preferable for a partnership that realizes capital gains to be the investor that invests in a QOF. (Skipping over the obvious circumstances, here is one that is less obvious, but important to bear in mind. For purposes of determining whether a sale is to a related party, a 20% test is imposed by the QOZ program in applying Code Sections 267(b) and 707(b). If the partnership does not elect to invest in a QOF in connection with a disposition of a partnership asset resulting in a capital gain, the related party test is imposed at the partner level. Accordingly, one should bear in mind that a purchaser that is treated as unrelated to the partnership may be a related person with respect to a partner.) However, given the significant areas of uncertainty that remain under the QOZ program where the partnership is the QOF investor, coupled with the timing benefits and greater certainty of results where the partnership elects not to invest in a QOF, in most instances it would seem that the latter option is the better of the two.

### Grace Period for QOF Investments

As previously discussed, Code Section 1400Z-2(d)(1) requires that a QOF has at least 90% of its assets invested in QOZ Property, and further requires that this be measured semi-annually on the last day of the sixth month and twelfth month of the QOF's taxable year. Unfortunately, for this purpose cash is not QOZ Property. Accordingly, from the time a taxpayer invests its capital gains in a QOF, the QOF may have as little as a single day and up to six months to invest a minimum of 90% of the gains in QOZ Property, depending upon when the contribution of Deferred Gains occurs. This clearly leaves the QOF very little time to act, as the failure to satisfy the 90% Test results in the imposition of penalties on the QOF. Unless the QOF is in the rare situation of being able to immediately acquire QOZ Business Property and commence operations, the QOF must quickly invest in QOZ Stock and/or QOZ Partnership Interests.

Having now passed two timing hurdles (the 180-day period to invest Deferred Gains in a QOF and the QOF's having to acquire QOZ Stock or QOZ Partnership Interests prior to the first 90% Test testing date), a third awaits—no more than 5% of the assets of a QOZ Business may be held in nonqualified financial property, subject to an exception for reasonable working capital reserves. In other words, other than the foregoing exception for working capital, cash is a "bad" asset when held by a QOZ Corporation or a QOZ Partnership as well as being a "bad" asset when held by a QOF. Reading the working capital exception generously, one could still not be confident that contributed cash could be held more than 12 to 18 months before having to be invested in QOZ Business Property. In sum, the various time periods contained in the statute quite effectively limited the ability to use the QOZ program for anything on a grander scale than a construction/rehabilitation of a modestly sized project—certainly nothing on the scale of development/redevelopment that would attract headlines and ribbon-cutting politicians, as such a project could take years to develop and place in service.

Treasury recognized that these meager time periods were stifling interest in the QOZ program, and that a grace period would need to be created to allow greater flexibility for larger-scale ribbon-cutting projects. The question became whether holding the cash at the QOF level (perhaps by utilizing the "reasonable cause" exception for avoiding 90% Test penalties) or at the QOZ Corporation/QOZ Partnership level did less damage to the language of the statute. Treasury ultimately chose the latter approach in the Proposed Regulations by expanding the working capital exception to the limit on nonqualified financial instruments.

The Proposed Regulations create a safe harbor for cash placed in a working capital reserve satisfying the following requirements. First, the amounts deposited into the working capital reserve must be specified in writing for use in the acquisition, construction and/or substantial improvement of property in a QOZ. Second, there must be a written schedule that is consistent with the ordinary startup of a trade or business and that provides a timeline (not to exceed 31 months) for the expenditure of the funds deposited in the reserve. Third, the funds must actually be spent in a manner consistent with the foregoing schedules. The Proposed Regulations further provide that, during the period of development activities in compliance with the safe harbor requirements, the Substantially All Test will not be treated as failed while the working capital funds are still being consumed. In addition, earnings on the working capital funds are treated as "good" earnings for purposes of the Gross Income Test.

A key element here is that the 31-month working capital exception is only available if a QOF invests in a QOZ Corporation or a QOZ Partnership. If a QOF invests directly in QOZ Business Property, it must almost immediately satisfy the 90% Test. (The 70% Substantially All Test is moot due to the 90% Test requirement.) Accordingly, one would expect to see very few instances in which a QOF invests directly in QOZ Business Property.

While the working capital safe harbor makes the QOZ program far more workable than otherwise provided under the statute, unfortunately, in many jurisdictions, 31 months isn't long enough to get permits for a hot dog stand, let alone anything approaching a large-scale development/redevelopment. Admittedly, Treasury's concern that a longer time period allows taxpayers to enjoy the benefits of the QOZ program without having actually invested the capital gains in the QOZ is legitimate. Further, one could argue that if state or local requirements for developing property are difficult and time-consuming to satisfy, it is up to those state and local governments to streamline their processes to allow for larger-scale QOZ development/redevelopment projects. Nonetheless, a 31-month grace period, while helpful, remains inadequate to allow for most ribbon-cutting projects. There are several ways in which Treasury's concerns can be addressed while allowing for larger-scale use of the QOZ program. For example, under the (now terminated) ARRA Section 1603 cash grant program for renewable energy projects, in dealing with the applicable time frames Treasury looked to whether the facility owner could demonstrate a course of continuous development activities. That approach could be relied upon in this context to allow for projects exceeding the 31-month period in the current safe harbor. Another possibility would be to allow QOFs to elect a development period more than 31 months' duration in exchange for a tolling of the 10-year holding period to qualify for the basis step-up. This latter approach addresses the concern with delaying the expenditure of cash by also delaying qualification for the basis step-up benefit and would also provide an incentive for QOFs to complete their projects as quickly as possible.

**Eligible Gains**

Code Section 1400Z-2(a) speaks in terms of "gains" resulting from a sale of assets to an unrelated person as qualifying for the QOZ program benefits. The Proposed Regulations, however, clarify that only gains qualifying for treatment as capital gains may be invested in a QOF and qualify for the QOZ benefits. Thus, for example, that portion of gain from the sale of an asset that represents depreciation recapture taxable as ordinary income, and that portion of gain from a sale of a partnership interest that is allocable to unrealized receivables under Code Section 751, do not qualify for QOZ benefits. The preamble to the Proposed Regulations state that Treasury's reading of the legislative history underlying the program, and the structure of the statute itself, suggest that Congress intended the QOZ program to apply only to capital gains and not to all gains. Fair enough—the Conference Report clearly speaks in terms of "capital gains" and not "gains," so while one could argue that the Proposed Regulations are overly restrictive in comparison to the statutory language, Treasury's position does appear to reflect Congressional intent.

### Ten-Year Rule Issues

As previously discussed, if a taxpayer invests in a QOF and holds the investment for a minimum of 10 years, upon disposition the taxpayer may elect to step up its basis in the QOF interest to avoid recognition of gain on the sale. Code Section 1400Z-1(f) states that the designation of a census tract as a QOZ remains in effect until the end of the tenth calendar year following the year in which the designation is made. This resulted in uncertainty as to whether the foregoing basis step-up remained available if the QOF interest was disposed of following expiration of the QOZ designation.

Fortunately, Treasury recognized that limiting the basis step-up to dispositions occurring prior to expiration of the designation would severely hamper the success of the QOZ program, as it would make the benefit of the basis step-up illusory in most cases. Accordingly, the Proposed Regulations provide that the basis step-up remains available for dispositions that occur on or before December 31, 2047, assuming that the QOZ Business continues to operate in compliance with the QOZ program requirements as if the loss of designation had not occurred. While this is helpful in providing a reasonably extended period to plan for the QOF interest disposition, one could legitimately question the necessity of an outside sale date, particularly given that no such outside date is contained in the statute. To be fair, Treasury does recognize that it has drawn an arbitrary line here, as the Proposed Regulations expressly invites comments on this issue and the preamble discusses some of the alternatives Treasury considered before adopting this approach.

A second issue of great significance relating to the basis step-up ties back to the entity/look-through discussion above in dealing with partnerships. That issue is whether the basis step-up is solely available for a disposition of an interest in a QOF or, alternatively, could the rule be applied looking through a QOF that is a partnership to apply the basis step-in connection with the sale of a QOZ Partnership Interest or the sale of QOZ Business Property by a QOZ Partnership. From the standpoint of administrative and structuring efficiency, the ability to look through conduit entities would be quite desirable, as it would allow a single QOF to make multiple investments without being burdened by the need to, in effect, sell the entire portfolio in one disposition to qualify for the basis step-up. Without such an ability to look through the entities, one is driven towards creating a separate QOF for each investment, which is inefficient and administratively burdensome. In addition, it requires a taxpayer that realizes a capital gain to be able to foresee the ultimate QOZ Business investments it will make prior to expiration of the 180-day period contribution period so that it invests the correct amount of money in the appropriate number of QOFs.

While the statute does speak solely in terms of the disposition of an interest in a QOF to qualify for the basis step-up, Treasury likely possesses the regulatory authority to permit a look-through rule in the case of a QOF that is a partnership and that either holds a QOZ Partnership Interest or that owns QOZ Business Property directly. In this author's view, this would be a very desirable result that would add to greater efficiency in administration and implementation of the QOZ program and does not seem to be inconsistent with Congressional intent. As previously discussed in some detail, though, Treasury needs to decide as a policy matter whether to treat a partnership as an entity for QOZ program purposes, or as a collection of partners with the provisions of the program looking through to the partners. The rule that the Proposed Regulations introduced allowing partners to invest separately in QOFs is a first step down the road to adopting the look-through approach as a policy matter, but there is no assurance that Treasury will continue walking in the same direction. This issue has been raised with Treasury and is not addressed in the Proposed Regulations, but hopefully will be considered for inclusion in future guidance.

## REVENUE RULING 2018-29

As previously discussed, one of the requirements for an asset to constitute QOZ Business Property is that it must either be new property or, if previously used, it must be substantially improved. The statute left unclear how land should be treated for this purpose. Revenue Ruling 2018-29 clarifies this issue. In the facts of the Ruling, the QOZ Business owner acquires an existing factory and the underlying land with the intent of converting the factory into a residential rental property. The Ruling first concludes that, in determining whether the owner has expended enough funds in rehabilitating the building to satisfy the "substantial improvement" requirement, the appropriate measure is that portion of the acquisition price attributable to the existing building (i.e., excluding the portion of the purchase price attributable to the land). It goes on to hold that, because in all instances land already exists and has been previously used, land is exempt from the substantial improvement requirement.

This author has heard some raise the concern that the Revenue Ruling suggests that, because land cannot satisfy the original use requirement and is excluded from the substantial improvement requirement, land cannot be treated as "good" QOZ Business Property. I do not believe this is a correct reading of the Ruling. The Ruling simply acknowledges that land cannot satisfy the original use test, and that there is no valid purpose for imposing a separate substantial improvement requirement on the land.

The Ruling does tangentially address one other issue that is raised by the statute. A QOZ Business is defined as a trade or business, and QOZ Business Assets must be used in that trade or business. Further, the Gross Income Test is determined with reference to the gross income derived from the active conduct of the trade or business. The statute does not address what constitutes the active conduct of a trade or business for these purposes. Based on prior tax-advantaged investment programs targeted at specific areas, there was a concern as to whether developing and operating residential rental property or developing and leasing nonresidential real property could constitute the active conduct of a trade or business.

The Proposed Regulations expressly reserve on this issue. However, given that the facts of the Ruling involve the acquisition of a factory in a QOZ for the purpose of converting it into residential rental housing, it would not be unreasonable to surmise that developing and operating residential rental property satisfies the active conduct of a trade or business requirement. That is as it should be. The clear intent of the QOZ program is to encourage taxpayers holding appreciated property to dispose of that property and invest the proceeds in distressed areas throughout the United States in the hope of using private enterprise to revitalize these areas that are most in need. There is nothing to be gained, and a great deal to be lost, if Treasury were to overlay the program with an unnecessary disqualification of investments of a more passive nature. For example, if a taxpayer realizes $50 million of capital gains, invests those gains in a QOF that, through a QOZ Corporation or a QOZ Partnership, builds a building for commercial use and leases it to one or more long-term tenants on a triple net basis, what policy is served by denying the QOZ program benefits on the basis that this model is not "active" enough? The taxpayer made the decision to sell appreciated property and use the gains for investment in a QOZ, just as Congress intended. Imposing a strict "active conduct" test would not only severely discourage participation in the QOZ program, it raises a legitimate concern about what type of development/redevelopment projects could satisfy such a test?

If you have any questions about the content of this Alert, please contact the author.