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GLOSSARY OF TERMS AND Q&A

The opportunity zone life cycle is rife with acronyms. Let's establish a brief glossary before we dig in any deeper:

QOZ: qualified opportunity zone. These are the designated areas in which a business must be conducted for any of the tax benefits to come to fruition.

QOF: qualified opportunity fund. A taxpayer who wishes to defer eligible gain must invest an amount equal to that gain into a QOF within 180 days of the sale. A QOF can be a C corporation, S corporation, or partnership.

QOZP: qualified opportunity zone property. A QOF must conduct a business in a QOZ, either directly or indirectly. This standard is tested every six months, and at each testing date, at least 90% of the assets of the QOF must be QOZP. QOZP can either be qualified opportunity zone business property (discussed below), or an interest in a subsidiary corporation or partnership that conducts a qualified opportunity zone business (also discussed below).

QOZB: qualified opportunity zone business. A QOF can conduct a business directly, or through a corporate or partnership subsidiary. If done through a subsidiary, the subsidiary must meet the definition of a QOZB.

QOZBP: qualified opportunity zone business property. As discussed more fully below, QOZBP is property purchased after 2017 from an unrelated party, and, in general, either 1. the "original use" of the property in the QOZ begins with the QOF or QOZB, or 2. the QOF or QOZB "substantially improves" the property. The latest regulations allow additional flexibility by allowing for leased property to qualify as QOZBP.

Is raw land considered QOZBP?

Q: When a QOF or QOZB acquires land, the land cannot satisfy the requirement that the original use of QOZBP begin in the QOZ with the taxpayer. This casts doubt on whether the value of land is counted toward the 90% or 70% test.

Rev. Rul. 2018-29 provided some clarity by stating that when a QOF or QOZB acquires land and a building together, provided the building is substantially improved within a 30-month period, the original-use requirement does not apply to the land on which the building is located. Thus, the value of both the land and the building will meet the definition of QOZBP. But what if a QOF or QOZB acquires only raw land and then constructs a new building? Can the conclusion reached in Rev. Rul. 2018-29 be expanded to exclude the land from the original-use requirement even when it is not purchased in conjunction with a building that is subsequently substantially improved? Neither Rev. Rul. 2018-29 nor the regulations address such a scenario.

If land purchased separately is not QOZBP because of the failure to satisfy the original-use test, how can raw land be substantially improved? What types of improvements increase the basis of raw land such that the 30-month test could be met?

A: The newly issued proposed regulations provide tremendous relief in this regard. the regulations state that a QOF or QOZB can purchase raw land, and even though the land cannot possibly satisfy the original use test, that land *does not need to be substantially improved.*

This could lead to potential abuses where a QOF engages in land speculation by purchasing raw land, opting not to construct a structure on the land, and sell the land after ten years tax-free. Remember, however, that as discussed above, a QOF or QOZB must *conduct a trade or business*, and holding raw land is not a trade or business. But what if a QOF puts a nominal structure on raw land, say...a hot dog stand. Could the QOF buy 100 acres it views as undervalued, operate a tiny hot dog stand on the land in order to satisfy the trade or business standard, and then ten years later, sell the land tax-free while all the while contributing nothing more to the residents of a QOZ then occasional indigestion?

What is a "trade or business" for purposes of the opportunity zone incentive?

The highest standard of a trade or business is found under Section 162, the provision that grants taxpayers the ability to claim a deduction for the ordinary and necessary operating expenses incurred while conducting a "trade or business." The Supreme Court has established that to qualify as a Section 162 trade or business, the activity can't be a sporadic amusement, but rather must be entered into for profit and conducted with continuity and regularity.

If the intention is that the activity of a QOF or QOZB must rise to the level of a trade or business under the meaning of Sec. 162, the relevant authority — to say nothing of the recently finalized regulations under Sec. 199A — would present a problem for property rented on a triple-net basis. The IRS has historically viewed these types of rentals as an investment rather than a Sec. 162 trade or business; as a result, if a QOF or QOZB constructs a building that is rented, for example, to Walmart on a triple-net basis, the IRS may take the position that the building is not used in a trade or business and should not count toward the 90% or 70% test. So what, exactly, is a "trade or business" for purposes of Section 1400Z-2?

A: Proposed Regulation 1.1400Z2(d)-1(c)(4)(ii) requires that a QOF conduct a trade or business *within the meaning of Section 162*. Proposed Regulation 1.1400Z2(d)-1(d)(2)(ii) requires the same of a QOZB. As discussed above, this presents a problem in the context of property rented on a triple-net basis. The regulations further provide that the ownership and operation (including leasing) of real property is the active conduct of a trade or business. The regulations state, however, that "merely entering into a triple-net lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business." As a result, a QOF or QOZB should structure any lease arrangement to avoid being classified as a triple-net lease.

For each tax year, a QOZB must satisfy the following requirements set forth by Sec. 1397C(b).

- At least 50% of the gross income must be derived from the active conduct of a trade or business in the QOZ (the "50%-of-income test");
- A substantial portion of the intangible property must be used in the active conduct of a trade or business in the QOZ (the "intangible test"); and
- Less than 5% of the aggregate unadjusted bases of the property of the trade or business is attributable to nonqualified financial property (the "5%-of-assets test").

Nonqualified financial property includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property. Excluded from the definition of nonqualified financial property are reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

The 5%-of-assets test would prove problematic for QOZBs that receive a large influx of investment capital but need time before they can convert that capital into tangible property.

To illustrate, a QOF may invest significant cash into a subsidiary partnership that intends to build affordable housing.

Absent an exception, while the subsidiary partnership is seeking approvals and beginning construction, the cash would be treated as nonqualified financial property. Fortunately, the proposed regulations contain such an exception in the form of a safe harbor.

Working capital assets are considered reasonable — and thus are not treated as nonqualified financial property — if the amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ. In addition, there must be a written schedule consistent with the ordinary startup of a trade or business for the expenditure of the working capital assets within 31 months of the business's receipt of the assets; and the working capital must actually be used in a manner that is substantially consistent with the written plan.

If these requirements are met, any gross income earned on the working capital throughout the 31-month period counts toward the satisfaction of the 50%-of-income test. Likewise, throughout the entire 31-month period, the business is treated as having satisfied the intangible test.

Ex. In 2019, Taxpayer H realized $10 million of capital gains and within the 180- day period invested $10 million in QOF. QOF immediately acquired from Partnership P a partnership interest in P, solely in exchange for $10 million of cash. P immediately placed the $10 million in working capital assets, which remained in working capital assets until used. P had written plans to acquire land in a QOZ on which it planned to construct a commercial building. Of the $10 million, $4 million was dedicated to the land purchase, $5 million to the construction of the building, and $1 million to ancillary but necessary expenditures for the project. The written plans provided for purchase of the land within a month of receipt of the cash from QOF and for the remaining $5 million and $1 million to be spent within the next 30 months on construction of the building and on the ancillary expenditures. All expenditures were made on schedule, consuming the $10 million. During the tax years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent amounts in the working capital assets, and P's work in process as the building was constructed.

P met the three requirements of the safe harbor. P had a written plan to spend the $10 million received from QOF for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ. P had a written *schedule consistent with the ordinary startup of a business for the expenditure of the working capital assets. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary startup of a business. Therefore, the $4 million, the $5 million, and the $1 million are treated as reasonable in amount. Because P had no other gross income during the 31 months at issue, 100% of P's gross income during that time is treated as derived from an active trade or business in the QOZ for purposes of satisfying the 50%-of-income test. For purposes of satisfying the intangible test, during the period of land acquisition and building construction, a substantial portion of P's intangible property is treated as being used in the active conduct of a trade or business in the QOZ.*

Can a QOF or QOZB lease property and have it meet the definition of QOZBP?

Q: The initial proposed regulations provided that a QOF must "purchase" QOZBP, while a QOZB could "purchase or lease" QOZBP. It was unclear, however, how a lease satisfied the purchase or original-use requirement if the leased property was already located within a QOZ. In addition, it was unclear how a QOF could "substantially improve" a lease.

A: The latest round of proposed regulations address this issue in detail. First and foremost, both a QOF and QOZB may now lease property. For leased property to meet the definition of QOZBP, however, the lease must be entered into AFTER December 31, 2017 and its terms must be arms-length. In general, two VERY favorable rules apply to leased property:

1. A lease does not need to satisfy the "original use" requirement, and
2. The QOF or QOZB is not required to "substantially improve" the lease.

Thus, a QOF can generally lease a building that has long existed in a QOF and need not substantially improve the property. This would enable a start-up company to lease its office space and have that lease meet the definition of QOZBP.

If a lease is between a QOF (or QOZB) and a related party, however, there are additional safeguards put into place by the new regulations. First, the lessee cannot make a prepayment on the lease relating to a period of use that exceeds 12 months. Then, in an exception to the general rule that the original use test does not apply to leased property, in order for property leased from a related party to count as QOZBP, the property must either 1. satisfy the original use requirement, or 2. during the 30-month period beginning with the inception of the lease, the QOF or QOZB must acquire other tangible QOZBP with a value equal to the value of the leased property. There is an important distinction here: the QOF or QOZB does not need to substantially improve the lease in any way, it simply must acquire other QOZBP with a value equal to the value of the lease, and that property can be completely unrelated to the leased property. For these purposes, leased property can be valued at either the value on an applicable financial statement, or by taking a present value of all lease payments on the date the lease is entered into. Be warned, however, that the latter value is determined on the date the lease is entered into and is used for the entire length of the lease; thus, this alternative valuation would not accurately capture a downturn in the market that reduces the value of the leased property.

Finally, if at the time a lease for real property is entered into (with a related or unrelated party) there is a plan or expectation for the leased property to be purchased by the QOF or QOZB for an amount other than the FMV determined at the time of purchase, *the property is not QOZBP*.