

# Treasury Releases Final Regulations For Qualified Opportunity Zones Program

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## **QUALIFIED OPPORTUNITY ZONES: FINAL REGULATIONS**

The U.S. Department of Treasury released [Final Regulations](#) for the Qualified Opportunity Zone (QOZ) program on December 19, 2019, which answer many, but not all, of the questions arising from the Proposed Regulations released in October 2018 and April 2019. On that same day, they also released [Frequently Asked Questions](#).

While much of the news will be welcomed by taxpayers who have (or who are looking to) invest in QOZs, pitfalls remain and at least for now, some questions remain unanswered.

## **OVERVIEW OF QUALIFIED OPPORTUNITY ZONE PROGRAM**

The QOZ program, introduced in 2017's Tax Cuts and Jobs Act, is an incentive program for investments in more than 8,700 QOZs located in all 50 states, the District of Columbia, and the five U.S. possessions.

The program's benefits include gain deferral and gain elimination for a taxpayer who (1) recognizes capital gain from the sale of an asset to an unrelated person, (2) invests an amount equal to all or part of the capital gain in a Qualified Opportunity Fund (QOF) within 180 days of the date the gain is recognized (with certain exceptions for pass-through entities), and (3) makes an election (on IRS Form 8949) to treat the investment as a QOZ investment.

QOZ benefits are: (1) deferral of the rolled-over gain until the earlier of when the taxpayer disposes of its QOF interest or December 31, 2026; (2) (a) elimination of 10% of the taxpayer's roll-over gain if the taxpayer holds its QOF interest for at least five years on or before December 31, 2026, and (b) elimination of another 5% of the taxpayer's roll-over gain (for a total of 15%) if the taxpayer holds its QOF interest for at least seven years on or before December 31, 2026; and (3) if the taxpayer holds its interest in the QOF for at least 10 years, no gain is recognized on a disposition of the investment, provided the disposition occurs on or before December 31, 2047.

### ***Qualified Opportunity Fund, Qualified Opportunity Zone Business Property***

An eligible entity, which is merely a partnership or corporation for federal income tax purposes (and not a disregarded entity), will qualify as a QOF provided that 90% or more of its assets (on average) are composed of (1) Qualified Opportunity Zone Business Property (QOZBP) and/or (2) interests in an eligible entity—a partnership or corporation (that is not a disregarded entity)—that qualifies as a Qualified Opportunity Zone Business (QOZB). The QOF 90% asset test is an average of the entity's assets on two annual snapshot testing dates—the end of the entity's first six months and the last day of its taxable year (with exceptions provided for a short taxable year). A grace period allows a QOF to ignore

contributed assets on the first testing date after those assets are contributed. Notably, cash and working capital are not “good assets” for purposes of the QOF 90% asset test. An eligible entity self-certifies as a QOF on IRS Form 8996.

A QOZB also must be an eligible entity, not a disregarded entity, and it must satisfy a variety of tests including (1) at least 70% of the tangible property it owns or leases is QOZBP; (2) at least 50% of its gross income is from the active conduct of a trade or business in a QOZ; (3) at least 40% of its intangible property is used in the active conduct of its business; (4) no more than 5% of the unadjusted basis of its assets are nonqualified financial property (NQFP); and (5) it is neither a “sin business” nor does it lease 5% or more of its assets to a sin business. In contrast to a QOF, a QOZB is permitted to hold reasonable working capital. As Ballard Spahr explained in our [webinars](#), because of the interaction between the tests that must be satisfied for an entity to qualify as a QOF or QOZB, many QOFs likely will be organized using a two-tier structure whereby investors invest in a QOF, which in turn invests in an entity that is a QOZB.

The statutory language creating the QOZ program and the Proposed Regulations released in October of 2018 and April of 2019 left many questions unanswered. Investors and promoters have been anxiously awaiting final guidance from the Treasury and the IRS on many issues. The Final Regulations answer many, but not all, of the questions.

The Final Regulations provide guidance on, among other things:

- Another 180-day period for an owner of a pass-through entity to roll-over gain recognized by the pass-through entity;
- A taxpayer selling one or more assets to a QOF or QOZB and rolling over the gain from the sale into the purchaser QOF or QOZB that owns an interest in the purchaser QOZB (i.e., circular cash flow);
- Favorable rules for gain recognized on the installment method;
- Code Section 1231 gain;
- The ability of a QOZB to sell QOZBP after 10 years;
- Events that end a QOF investor’s gain deferral;
- The valuation of QOZBP for purposes of the QOF’s 90% asset test and the QOZB’s 70% asset test;
- Reinvestment by a QOF of proceeds from a sale of QOZBP or an interest in an entity that is a QOZB;
- Permitting a QOZB to treat its property acquired or leased after December 31, 2017, as qualifying as QOZBP and as satisfying the active trade or business and other tests during the working capital safe harbor period;
- Aggregation rules for substantially improving assets purchased by a QOF or QOZB;
- What constitutes original use of tangible property for purposes of the substantial improvement requirements;
- Clarifying what constitutes “straddle property” (i.e., property that is both in and out of a QOZ);
- What constitutes the active conduct of a trade or business, including triple net leased property;
- Sourcing of gross income of a QOZB to a QOZ; and
- Anti-abuse rules.

The Final Regulations will be effective on March 13, 2020, and are applicable to a taxpayer’s first tax year beginning after March 13, 2020. For tax years beginning before March 13, 2020 (the 2017-2020 calendar years for a calendar year taxpayer), a taxpayer can choose to rely on all of the rules in the Final Regulations or all of the rules in the Proposed Regulations.

## **FINAL REGULATIONS: QOF INVESTOR GUIDANCE**

An investor is eligible for QOZ benefits if, within 180 days of recognizing capital gain (long-term or short-term) from the sale of property to an unrelated person, the investor invests an amount equal to all or part of that capital gain in a QOF.

### ***180-Day Roll Over Period***

Either a partnership or its partners may roll over capital gains recognized by the partnership into a QOF. If a partnership rolls over the capital gain into a QOF, the partnership has 180 days from the date it recognizes the gain to invest in a QOF. If a partner in a partnership that recognizes capital gain rolls over its share of the gain, its 180-day period starts at the partner's election on (1) the date the partnership recognizes the gain, (2) the last day of the partnership's tax year, or (3) a new date added by the Final Regulations, the due date, without extension, for the partnership's tax return for the year it recognized the gain. Similar rules apply for S corporations.

The Final Regulations provide special rules to determine when the 180-day period starts for REIT shareholders and mutual fund shareholders.

### ***Circular Cash Flow – Rolling Over Gain to a QOF from a Sale of Property to the QOF or the QOF's QOZB***

To be eligible to obtain QOZ benefits, a taxpayer must recognize capital gain from the sale of property to an unrelated party. Under general principles of tax law, if a taxpayer sells property to an entity and, as part of a plan, reinvests the proceeds of the sale in the purchasing entity, the sale is disregarded and the transaction is treated as a capital contribution. It has been an open question as to whether a taxpayer would be eligible for QOZ benefits if the taxpayer sells property to a QOF or a QOF's QOZB and invests an amount equal to the gain from the purported sale in the same QOF or QOZB.

The Preamble to the Final Regulations explains that, consistent with general tax principles, a taxpayer's gain from a sale of property to an unrelated QOF or its QOZB is not eligible gain if there was a plan to invest the consideration from the sale back into the QOF that purchased or whose QOZB purchased the property. Moreover, any property acquired by a QOF or QOZB in this manner would not be acquired by such QOF or QOZB by purchase and, as such, could not be QOZBP.

### ***Installment Sales***

The Final Regulations permit a taxpayer to roll over gain from an installment sale to an unrelated party. In the case of an installment sale, the taxpayer's 180-day period starts either on the date the gain from an installment payment is recognized or on the last day of the taxpayer's tax year, at the election of the taxpayer.

### ***Section 1231 Gain***

Code Section 1231 applies to depreciable property and real property used in a trade or business that is held for more than one year. Net Section 1231 gain is treated as long-term capital gain (subject to a recapture rule) and net Section 1231 loss is treated as an ordinary loss. Because a taxpayer will not know if it has net Section 1231 gain until the end of a tax year, the Proposed Regulations treat net Section 1231 gain as recognized on the last day of the tax year and started an investor's 180-day period to roll over the gain on that date. This created a less favorable result for Section 1231 gains than for other capital gains because only the net amount of Code Section 1231 gains could be rolled over into a QOF and the 180-day period did not start until the last day of the taxpayer's tax year.

The Final Regulations fix these issues by treating Code Section 1231 gain like other capital gains. First, there is no netting of the Code Section 1231 gain and losses to determine the Code Section 1231 gain that is eligible to be rolled over. Second, taxpayers are not required to wait until the last day of their tax years to start their 180-day roll-over period. As is true of other capital gains, if Code Section 1231 gain is recognized by a partnership or S corporation, the partnership or S corporation may roll over the gain into a QOF within 180 days of the sale or the owners of the partnership or S

corporation may roll over the gain. If the owners roll over the gain, their 180-day period would start, at their election, on (a) the day of the sale, (b) the last day of the partnership's or S corporation's taxable year, or (c) the due date, without extension, for the partnership's or S corporation's tax return for the year of the sale.

When a taxpayer ultimately recognizes Code Section 1231 gain that is rolled over on December 31, 2026 or earlier, upon an inclusion event, the taxpayer will have to recapture any Code Section 1231 losses it took in the prior five years from the recognition of the roll over Code Section 1231 gain.

### ***QOF Investment Unwind – 10-Year Benefit – Pass-Through Entity***

The Code provides that, upon a QOF investor's sale or exchange of its QOF interest, the QOF investor will not recognize gain provided that the QOF investor held its interest in the QOF for at least 10 years. The Proposed and Final Regulations also require that the QOF investor dispose of its QOF interest on or before December 31, 2047. As a technical matter, the gain is eliminated by allowing the QOF investor to elect to step-up its tax basis for its QOF interest to its fair market value immediately before the sale.

The Proposed Regulations extend the 10-year benefit to a sale by a pass-through QOF of its QOZBP or its interest in a QOZB, but do not allow a QOF investor to obtain the 10-year benefit if the QOZB sold its property. In addition, if the pass-through QOF sold its property, a QOF investor would have to recognize as ordinary income any recapture income.

The Final Regulations further expand the 10-year benefit available to a pass-through QOF owner. A qualifying investor in a pass-through QOF that has held its interest in the QOF for at least 10 years may exclude (1) gain recognized by the pass-through QOF on the sale of QOZBP or an interest in a QOZB and (2) gain on a sale by a partnership QOZB (an interest in which is owned by the QOF). In addition, the Final Regulations provide that the qualifying investor will not recognize any recapture income (which otherwise would be ordinary income). A qualifying investor in a pass-through QOF will recognize ordinary income from the sale by the QOF or by its pass-through QOZB of inventory.

If a QOF or QOZB sells an asset resulting in a gain that a qualifying QOF investor elects to exclude and the QOF does not distribute the proceeds of such sale to the qualifying investor, the Final Regulations treat the qualifying investor as having received a distribution of the proceeds and recontributed those proceeds as a capital contribution to the QOF as a nonqualifying investment, creating a mixed fund investment for the investor. It is unclear how this deemed distribution/recontribution regime impacts an investor's ability to exclude gain on the sale by the QOF or QOZB of assets acquired before such sale.

### ***Partnership QOFs – Inclusion of Debt in the Tax Basis for a QOF Investor's Interest in a QOF and Debt-Financed Distributions***

Generally, a partner in a partnership includes its share of the partnership's liabilities in its tax basis for its partnership interest in accordance with the rules under Code Section 752. The statutory language creating the QOZ program raises concerns as to whether the ordinary rules applicable to inclusion of partnership liabilities in a partner's basis for its partnership interest would apply to an investor's interest in a partnership QOF. The Proposed and Final Regulations make clear that a partner's basis for its qualifying interest in a QOF includes the partner's share of liabilities under Code Section 752.

The Final Regulations retain the rule included in the Proposed Regulations limiting the ability of a partner to receive debt-financed distributions while maintaining its qualifying interest in a QOF by applying modified disguised sales rules to debt-financed distributions from a partnership QOF. In essence, a debt-financed distribution to a partnership QOF investor within two years of the investor's qualifying contribution to the QOF will cause the QOF investor to

recognize all or part of its deferred gain. However, if the QOF investor keeps its interest in the partnership QOF, the QOF investor remains eligible for the 10-year benefit. For our technical readers, see Treas. Reg. § 1.1400Z2(a)-1(c)(6)(iii)(A)(2) on pages 388-389 of the Final Regulations. However, the normal exceptions to the disguised sale rules, such as the exception for distributions of operating cash flow, apply to distributions from QOFs. Even *after two years*, consideration must be given to the partnership disguised sales rules to determine if a debt-financed distribution could impact a QOF investor's QOZ benefits.

### ***Carried Interests***

The Final Regulations, like the Proposed Regulations, make clear that a partnership interest received for services is not eligible for QOZ benefits. This is true whether the interest is a profits interest or a capital interest acquired for services. A carried interest or capital interest acquired for services is treated as an interest in a mixed fund. See "Mixed Funds" below. The amount treated as a mixed investment is the share of the residual profits the carried interest holder would receive with respect to the carried interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application.

### ***Mixed Funds***

If not all of an investor's investment in a QOF is eligible for the deferral election, the investment has mixed funds. A mixed-fund investment results if: (1) the QOF investor's investment in a QOF is more than the amount of the investor's eligible capital gains, (2) the QOF investor contributes property (other than cash) to the QOF with a fair market value that exceeds the investor's adjusted basis for such property, (3) the investor makes any other type of nonqualifying contribution to a QOF, (4) as noted above, the investor is deemed to contribute its share of the proceeds from a sale (producing gain the QOF investor elects to exclude under the 10-year benefit) by its pass-through QOF of QOZBP or an interest in a QOZB or the QOF's pass-through QOZB's sale of assets, or (5) the investor holds a qualifying interest and a carried or profits interest in a partnership QOF.

If an investor has an investment in a QOF with mixed funds, the investor is treated as having two investments: one that qualifies for QOZ benefits and one that does not. The Final Regulations adopt the methodology included in the Proposed Regulations for allocating gains and other items among the qualifying and nonqualifying investments for a QOF investor with a mixed-funds investment.

### ***Transactions Causing Deferred Gain to be Recognized – Inclusion Events***

Subject to the five- and seven-year holding period gain elimination rules, deferred gain must be recognized on the earlier of the date that the QOF investor sells or exchanges its QOF interest or December 31, 2026. Transactions that require deferred gain to be recognized before December 31, 2026 are called "inclusion events." An inclusion event that involves a QOF investor disposing of all or part of its QOF interest terminates the QOF investor's ability to obtain the 10-year benefit with respect to such QOF interest.

Generally, any transaction that reduces a QOF investor's interest in a QOF is treated as an inclusion event. Examples of inclusion events include distributions from a QOF that result in the QOF investor recognizing gain (*e.g.*, a distribution in excess of the QOF investor's adjusted basis for its QOF interest) and gifts. Helpfully, death is not an inclusion event; beneficiaries essentially step into the shoes of the deceased (but without a basis step-up for the deferred gain). A transfer of a QOF interest to a grantor trust is not an inclusion event. Also, generally, a tax-free contribution of a QOF interest to a partnership is not an inclusion event.

The Final Regulations clarify that if a QOF investor in a partnership QOF receives a distribution in excess of basis and retains its QOF interest, that investor remains eligible for the 10-year benefit. The Final Regulations also include rules addressing when a variety of transactions, including the following, are inclusion events: partnership mergers, corporate reorganizations, and changes in entity classification.

### ***Step-Up in Basis at Death***

The Final Regulations clarify that there is no step-up in the basis for a QOF interest upon the death of the owner thereof, either before January 1, 2027 or after December 31, 2026.

***Ballard Spahr Tip:*** For individual taxpayers deciding between taking advantage of a Code Section 1031 exchange and the QOZ program, the lack of a step-up in basis at death is a factor to be considered.

## **FINAL REGULATION: QOF GUIDANCE**

### ***QOF 90% Asset Test – Grace Period - Temporary Investment Permitted for Six Months***

At least 90% of a QOF's assets must be either QOZBP or interests in a QOZB, and notably cash and working capital are not "good assets" for purposes of this 90% asset test. The Final Regulations retain the six-month grace period for a QOF to invest capital contributions it receives. Provided that capital contributions received by a QOF are invested by the QOF in cash, cash equivalents, or debt instruments with a term of 18 months or less, such amounts will be ignored for six months from the QOF's receipt of such capital contributions for purposes of the QOF 90% asset test. For any property received by the QOF as a capital contribution, the Final Regulations allow the QOF five days to convert that property into cash, cash equivalents, or debt instruments with a term of 18 months or less.

***Ballard Spahr Tip:*** This rule alleviates the concern that a QOF may need to act quickly to spend contributed cash before a testing date to satisfy the QOF 90% asset test and should greatly assist existing QOFs in managing the timing of the admission of new investors to the QOF in relation to the deployment of the funds into QOZBP or an entity that is a QOZB. For example, if a QOF receives cash as a capital contribution the first day after a testing date, since the investment would not be counted on the next six-month testing date, this grace period would allow the QOF, until the subsequent six-month testing date, to deploy the investment, which effectively results in 364 days for the QOF to deploy the funds.

***Ballard Spahr Tip:*** Notwithstanding that the Final Regulations allow a taxpayer to contribute property other than cash to a QOF, any property received as a capital contribution by a QOF will not qualify as QOZBP and cannot be contributed by a QOF to a QOZB for a qualifying QOZB interest.

During 90% of the time that a QOF owns an interest in a subsidiary partnership or corporation, that subsidiary partnership or corporation must be a QOZB. The Final Regulations provide rules for a QOF to determine if it meets this 90% test.

The QOF can treat the subsidiary as a QOZB if the subsidiary is a QOZB for at least 90% of the QOF's cumulative holding period for its ownership interest in the subsidiary beginning on the effective date of the QOF's status as a QOF and ending on the last day of the subsidiary's most recent tax year that ends before the QOF's semi-annual testing date. The rules also allow a subsidiary to qualify as a QOZB that otherwise would not be a QOZB on the last day of its tax year that ends before the QOF's semi-annual testing date if the QOZB cures its noncompliance and the QOF timely files its tax return (for its tax year including the testing date) no later than the date that the cure is achieved.

If, on a semi-annual testing date, a QOF would fail to have at least 90% of its assets in QOZBP or interests in one and/or more QOZBs, the QOF may treat its ownership interest in a subsidiary as an interest in a QOZB for that semi-annual testing date provided the subsidiary cures the failure to qualify as a QOZB within six months of the date it failed to qualify. If the failure occurs on the last testing date of a QOF's tax year, the QOF must timely extend the due date for its tax return to avail itself of the cure. A QOF can avail itself of a cure for a subsidiary only once. If the subsidiary's failure is not cured, the QOF becomes subject to penalties beginning with the first month following the last month that the QOF satisfied its 90% asset test.

There seems to be inconsistent requirements regarding the QOF's return filing requirements in connection with availing itself of a cure under these rules. The QOF seems to be required both to go on extension to allow for the cure and to file before the cure is achieved. Hopefully, the Treasury and IRS will address this discrepancy.

### ***QOF Reinvestment – Churning***

The Final Regulations incorporate the rules in the Proposed Regulations permitting a QOF to reinvest (1) a return of capital from the QOF's investments in a QOZB and (2) proceeds from the sale or disposition by the QOF of QOZBP. A QOF may reinvest such amounts in QOZBP or into an entity that is a QOZB, provided that such amounts are invested within 12 months from the date of the distribution or sale/disposition and, during such 12-month-period, the proceeds are continuously held in cash, cash equivalents, and/or debt instruments with a term of 18 months or less. To the extent this 12-month period is not met because of a delay in government action the application for which is complete, the 12-month period can be extended. Reinvestments that satisfy these rules (1) do not reset any QOF investor's applicable investment holding period, (2) do not impact the QOF 90% asset test, and (3) are not limited to reinvestments into the same type of QOZBP or into the same QOZB as the first investment.

The Preamble to the Final Regulations explains that a QOZB can reinvest proceeds from a sale of its assets by using the 31-month working capital safe harbor, as described below. However, the QOF investor must recognize the gain on the disposition of the QOZBP or of an interest in an entity that is a QOZB if the QOF is a pass-through entity (or the QOF must recognize the gain if the QOF is a corporation), as the Treasury Department and IRS could not find precedent to allow for nonrecognition.

***Ballard Spahr Tip:*** *The requirement that gain on the sale/disposition of assets be recognized limits the usefulness of this rule, as the resulting tax liability on interim sales/dispositions negatively impacts the QOF's return on investment. Tax liability on interim sales/dispositions also will potentially diminish the 10-year exclusion benefit since the exclusion of gain would apply only to the then-current investment held by the QOF.*

### **QOF DECERTIFICATION**

The Final Regulations include guidance addressing how a QOF may voluntarily decertify its QOF status to avoid penalties.

## FINAL REGULATIONS: QOZBP AND LEASED PROPERTY GUIDANCE

### *Purchased Property*

QOZBP is property (1) purchased by a QOF or an entity that is a QOZB from an unrelated person (“related” meaning more than 20% common ownership) after December 31, 2017, (2) (a) the original use of which in the QOZ commences with the QOF or the QOZB (the “original use test”) or (b) the QOF or QOZB substantially improves such property (the “substantial improvement test”), and (3) 70% of the use of which is in a QOZ during 90% of the time it is held by the QOF or the QOZB.

Property is substantially improved if, during any 30-month period that such property is held by a QOF or QOZB, the QOF or QOZB spends more than its adjusted tax basis for the property at the beginning of the 30-month period. If, however, the property is land and improvements all of which are located in a QOZ that was acquired after December 31, 2017, the QOF or QOZB only must spend more than its adjusted tax basis for the improvements, not the land, at the beginning of such 30-month period.

Property that is undergoing a substantial improvement is treated as QOZBP during the 30-month substantial improvement period, so long as the QOF or QOZBP reasonably expects that the property will be substantially improved and that the property will be used in the QOF’s or QOZB’s trade or business by the end of the 30-month period.

### *Substantial Improvement Test – Multiple Assets- Aggregation*

The Proposed Regulations explained that the substantial improvement test has to be satisfied on an asset-by-asset basis. The Final Regulations provide relief from the asset-by-asset rule by allowing aggregation of assets in certain circumstances.

A QOF or QOZB can include the cost of purchased property that otherwise qualifies as QOZBP to determine whether the additions to basis for non-original use property constitute a substantial improvement if the purchased property is (1) in the same or a contiguous QOZ as the non-original use property, (2) used in the same trade or business as the non-original use property, and (3) improves the functionality of the non-original use property.

The Final Regulations provide for the aggregation of certain purchased buildings (Eligible Building Group). An Eligible Building Group may be treated as a single property, and the relevant adjusted tax basis that must be considered to determine if there has been a substantial improvement is the additions to the basis of each building in the Eligible Building Group. An Eligible Building Group is (1) all buildings within the borders of a single land parcel described in a single deed or (2) buildings within contiguous parcels described in separate deeds, to the extent that each building is operated as one or more trade or businesses that (a) are operated exclusively by the QOF or QOZB, (b) share facilities or centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources, and (c) are operated in coordination with, or reliance on, one or more of the trades or businesses, such as supply chain interdependencies or mixed-use facilities.

“Contiguous property” is not defined for purposes of these aggregation rules. However, contiguous property is defined for purposes of straddle real estate as described below. It may be that the straddle real estate definition of contiguous applies for these purposes as well.

### *Leased Property*

The Final Regulations slightly modify the taxpayer-friendly rules for property leased by a QOF or QOZB that are in the Proposed Regulations. Leased property will qualify as QOZBP if (1) the property is leased pursuant to a lease entered into

after December 31, 2017, (2) the lease terms are arms-length at the time the lease is entered into, (3) during at least 90% of the QOF's or QOZB's (as the case may be) holding period for such leased property, 70% of the leased property's use is in a QOZ, and (4) if the lease is with a related party ("related" means more than 20% common ownership), (i) the lessee cannot make any prepayments of rent for a period exceeding 12 months, (ii) if the leased property is *tangible personal property* and the original use of such property in a QOZ did not commence with the lessee, the lessee must become the owner of *tangible property* in an amount at least equal to the value of the property leased from a related person within the earlier of (a) 30 months after the lessee receives possession of the leased property or (b) the end of the lease term, and (iii) there must be substantial overlap in the QOZs where the leased property and the property acquired in (ii) is used.

There is a presumption that leases between unrelated parties are at arms-length terms, and leases with state, local, and Indian tribal government are deemed to be at arms-length. The Proposed Regulations provide that, if there is a plan, intention, or expectation that leased real property (other than unimproved land) is to be acquired by the QOF or QOZB for other than the fair market value of such property, the property never will be QOZBP. The Final Regulations retain this rule and extend it to unimproved land as well.

Property leased after December 31, 2017, is not required to be substantially improved.

### ***Original Use Test Generally***

The Proposed Regulations define "original use" by reference to when the property first is placed in service by *any* taxpayer for depreciation purposes. As a result, if the property was ever placed in service by any person, it has been originally used. If the original use was in a QOZ, that property must be substantially improved. Also, improvements made to leased property satisfy the original use test and are treated as acquired by purchase. The Proposed Regulations provided relief from the original use requirement for property (including a building or other structure) that has been vacant or unused for at least five years before purchase by a QOF or QOZB by allowing the QOF or QOZB to satisfy the original use test by placing the unused or vacant asset into service in the QOZ without requiring that such property be substantially improved.

The Final Regulations provide more lenient vacancy rules. Property is treated as original use property if (1) it was vacant (*i.e.*, 80% of the square footage is not currently being used) for at least one year prior to the date of the notice of the parcel's designation as a QOZ, and the property was vacant when purchased by the QOF or QOZB, and (2) the property was vacant for at least three years and was vacant when purchased by the QOF or QOZB.

### ***Land***

The Final Regulations adopt the rule in the Proposed Regulations that if unimproved land acquired or leased after December 31, 2017 is used in a trade or business, such land generally is treated as QOZBP and neither the original use test nor substantial improvement test must be satisfied. However, because leaving land fallow is inconsistent with the intent of the QOZ program, vacant or minimally improved land purchased by a QOF or QOZB with no intention or expectation that the land will be materially improved does *not* constitute QOZBP.

***Ballard Spahr Tip:*** *These safe harbors should allow substantial flexibility for QOZBs that plan accordingly. The location of the QOZB's customers is largely irrelevant, so a QOZB can locate its activities in the QOZ even if its customer base is not within the QOZ.*

The Final Regulations confirm that if a QOF or QOZB purchases a building under construction before it is placed in service, that building will satisfy the original use test. Also, the Final Regulations provide that property purchased by a QOF or QOZB from a local government satisfies the original use test if the local government acquired the property as a result of an involuntary transfer including an abandonment, bankruptcy, foreclosure, or receivership.

### ***Valuation***

The Final Regulations adopt the two valuation methods for the QOF 90% asset test and the QOZB 70% asset test that are included in the Proposed Regulations with certain modifications. The first method is the applicable financial statement valuation method – valuation of tangible property is based on the book value (after depreciation and amortization) reported on an applicable financial statement. The second method is the alternative valuation method – valuation of tangible property is based on the original cost basis for the property. A QOF or QOZB may choose which method to use annually, and there is no consistency requirement from year-to-year. The Final Regulations provide that, if a QOF or QOZB uses the second method – original cost basis – it may use that method for property acquired by purchase for fair market value or constructed for fair market value. For all other property, the QOF or QOZB must use the fair market value of the property on the last day of the QOF's six-month testing period. This rule requires a QOF to determine the fair market value of its QOZB interest on its semi-annual testing dates.

Special valuation rules are provided for leased property. One valuation method is the applicable financial statement valuation method. Alternatively, the leased property may be valued by calculating the present value of the lease payments using the short-term applicable federal rate (based on semi-annual compounding) as the discount rate. If the lease is valued on the present value method, the value is determined when the lease is entered into and used for all testing dates.

### ***“Substantially All”***

The Final Regulations retain the various definitions of what constitutes “substantially all” where that term is used in the provisions governing QOZ benefits: (1) substantially all of a QOZB's tangible property owned or leased must be QOZBP (at least 70%); (2) tangible property is QOZBP if, among other things, during substantially all of the QOF's or QOZB's (as the case may be) holding period for such property (at least 90%), substantially all of the use of such property is in a QOZ (at least 70%); and (3) for substantially all of the time a QOF owns an interest in a subsidiary (at least 90%), the subsidiary must be a QOZB. Inventory may be excluded from both the numerator and denominator at the election of the QOF or QOZB, and such election is irrevocable.

Among the requirements for tangible property to qualify as QOZBP is that, during at least 90% of the QOF's or QOZB's holding period for the tangible property, 70% of the use of the tangible property is in a QOZ. The Final Regulations set forth the tests for satisfying this requirement.

Not less than 70% of the total utilization of the tangible property is within a QOZ based on the number of days between a QOF's two consecutive semi-annual testing dates. If tangible property is used by the QOF or QOZB to render services both inside and outside of a QOZ, up to 20% of the tangible property will satisfy this test if (1) the tangible property directly generates gross income for the QOZ or QOZB both inside and outside of a QOZ, (2) the QOF or QOZB has an office or other facility located within a QOZ, (3) the tangible property is operated by employees of the QOF or QOZB in the course of carrying out their duties and such employees are managed (directly, actively, and substantially) on a day-to-day basis by one or more employees of the QOF or QOZB who work in an office in a QOZ, and (4) the tangible property is not operated exclusively outside of a QOZ for longer than 14 consecutive days for the generation of gross income for the QOF or QOZB.

There is a special rule for tangible property leased to customers of the QOF or QOZB. If a QOF or QOZB has an office with employees in a QOZ, such leased property can satisfy this test if (1) it is consistent with the normal, usual, or customary conduct of its trade or business, (2) when the tangible property is not leased to customers, the tangible property is parked or stored at the QOZ office, and (3) when the customer acquires possession of the tangible property under the lease, the lease term, including extensions, cannot be longer than 30 consecutive days.

## **FINAL REGULATIONS: QOZB GUIDANCE**

To qualify as a QOZB, an entity must be a subsidiary of a QOF that is a partnership or corporation for tax purposes and: (1) at least 70% of the tangible property the entity owns or leases is QOZBP, (2) at least 50% of the entity's gross income is from the active conduct of a trade or business in a QOZ, (3) at least 40% of the entity's intangible property is used in the active conduct of its business, (4) no more than 5% of the unadjusted basis of entity's assets are NQFP, and (5) the entity does not conduct a sin business.

### ***Sin Business – Leasing to a Sin Business***

A sin business is any 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. The Final Regulations provide that, not only can a QOZB not operate a sin business, it also cannot lease 5% or more of its assets to a sin business.

### ***Property Straddling a QOZ***

The Final Regulations provide that, for purposes of determining if at least 50% of the gross receipts of a QOZB are from the active conduct of a trade or business in a QOZ, (1) at least 40% of a QOZB's intangible property is used in a QOZ and (2) during at least 90% of the time a QOF or QOZB holds QOZBP, at least 70% of the use of that QOZB is in a QOZ, and certain real property straddling a QOZ is treated as if it were all in the QOZ. The straddle rules apply if (1) the real property located inside and outside of a QOZ is used in the trade or business in carrying on its business activities, (2) the amount of real property located within a QOZ is substantial compared to the amount of property located outside of a QOZ, and (3) the real property located in the QOZ is contiguous to all or part of the real property located outside of the QOZ.

Whether the real property located inside of the QOZ is substantial as compared to the real property located outside of the QOZ is based on meeting either one of two tests. The first test is whether the square footage of the real property located inside the QOZ is more than the square footage of the property outside the QOZ, and the square footage outside the QOZ is contiguous to all or part of the real property inside the QOZ. The second test is whether the unadjusted cost of the real property located inside the QOZ is greater than the unadjusted cost of the real property located outside of the QOZ and the real property outside of the QOZ is contiguous to all or part of the real property located inside of the QOZ.

Contiguous for these purposes means two or more tracts or parcels of land that share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream, or similar property. However, tracts or parcels that touch only at a common corner are not contiguous.

### ***Active Conduct of a Trade or Business***

Consistent with proposed regulations addressing other provisions of the Tax Cuts and Jobs Act, neither the Proposed Regulations nor the Final Regulations provide meaningful guidance as to what constitutes the "active conduct of a trade or business" for purposes of the requirement that at least 50% of the total gross income of a QOZB be derived from the active

conduct of a trade or business within a QOZ. Instead, the Proposed and Final Regulations refer to the general rules under Code Section 162(a), but notably provide for special rules for rental real estate.

The ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business for purposes of the QOZB provisions. However, like the Proposed Regulations, the Final Regulations provide that merely entering into a triple net lease is not the active conduct of a trade or business. The Final Regulations include two examples addressing triple net-leased property. In one example, a landlord constructs a building and leases the entire building to a single tenant on a triple net basis whereby the tenant is responsible for all costs relating to the building. The landlord maintains an office in the building with staff members to address issues that may arise with respect to the triple net lease. The Final Regulations conclude that the landlord is not engaged in an active trade or business.

In the second example, the landlord constructs a three-story building and leases each floor to a different tenant. The lease to the tenant for the third floor is a triple net lease whereby the tenant pays all of the costs relating to the third floor of the building. The other two leases are not triple net. The landlord maintains an office in the building with employees and the employees regularly carry out managerial and operational duties with respect to the first and second floors and address any other issues that may arise with respect to all three leases. The Final Regulations conclude that the landlord is engaged in an active trade or business.

### ***Sourcing Gross Income to a QOZ***

The Final Regulations adopt the guidance from the Proposed Regulations on the sourcing of gross receipts to a QOZ, with modifications. There are three proposed safe harbors to calculate whether at least 50% of a QOZB's gross income is sourced to a QOZ:

- Hours Test, if at least 50% of the services are performed in the QOZ, determined by comparing the hours of work performed for the business by its employees, partners (but it is unclear whether only hours compensated with guaranteed payments count) and independent contractors (and employees of independent contractors) within the QOZ to the total hours of work performed for such business by its employees, partners as guaranteed payments, and independent contractors (and employees of independent contractors);
- Pay Test, if at least 50% of the services are performed in the QOZ, determined by comparing the amounts paid by a business to its employees, partners as guaranteed payments, and independent contractors (and employees of independent contractors) for services performed in the QOZ to the total amount paid by the business for employees, partners as guaranteed payments, and independent contractors (and employees of independent contractors) for services performed during the taxable year; or
- Qualitative Test, a qualitative determination that the tangible property of the business that is in a QOZ and the management or operational functions performed in the QOZ are each necessary to generate at least 50% of the gross income of the trade or business.

The inclusion of independent contractors and the employees of independent contractors may complicate the analysis for the first two safe harbors. In addition, a business could try to apply a facts-and-circumstances analysis if it fails to meet any of the three safe harbors.

***Ballard Spahr Tip:*** *These safe harbors should allow substantial flexibility for QOZBs that plan accordingly. The location of the QOZB's customers is largely irrelevant, so a QOZB can locate its activities in the QOZ even if its customer base is not within the QOZ.*

## *Intangible Property*

With respect to the use of intangibles by a QOZB, the Final Regulations adopt the rules in the Proposed Regulations providing that at least 40% of the intangible property of a QOZB must be used in the active conduct of a trade or business in a QOZ. Intangible property is used in the active conduct of a trade or business in a QOZ if the use of the intangible property is normal, usual, and customary in the conduct of the trade or business and the intangible property is used in the QOZ in the performance of an activity of the QOZB that contributes to the generation of the QOZB's income. The Final Regulations do not provide for a safe harbor method for measuring this 40% test.

## *Working Capital Safe Harbor*

Pursuant to the Code, no more than 5% of the unadjusted basis of a QOZB's assets may be NQFP. NQFP includes cash, notes, bonds, interests in subsidiaries that are regarded entities for federal income tax purposes, options, warrants, annuities, and other similar assets. However, NQFP does not include reasonable working capital – a QOZB may hold reasonable working capital. The Final Regulations retain the working capital safe harbor included in the Proposed Regulations with some modifications. The 31-month working capital safe harbor requires that: (1) the working capital is designated for the acquisition, construction, and/or improvement of tangible property or development of a business in a QOZ, (2) there is a written schedule consistent with the ordinary startup of a trade or business for the expenditure of the working capital, (3) the working capital is spent within 31 months of the receipt of the funds, and (4) the working capital is used substantially consistent with the foregoing.

A QOZB will not fail to meet the working capital safe harbor if the 31-month period is exceeded because the delay is attributable to waiting for government action, the application for which is completed during the 31-month period. If the QOZ is in a federally declared disaster area, the QOZB may receive up to an additional 24 months to consume its working capital.

A QOZB may have multiple sequential 31-month working capital safe harbor periods and a new 31-month safe harbor period begins each time the QOZB receives funds. During the period that the working capital safe-harbor is satisfied, NQFP in excess of the 5% NQFP limitation will not cause an entity to fail to qualify as a QOZB and (1) the gross income earned on such working capital by the business will satisfy the requirement that at least 50% of the entity's gross income must be from the active conduct of a trade or business in a QOZ, (2) intangible property purchased or licensed by the QOZB, pursuant to the written plan, satisfies the requirement that at least 40% of a QOZB's intangible property must be used in a QOZ, and (3) if the tangible property to which the working capital is being applied is expected to be QOZBP as a result of the application of the working capital, the tangible property purchased, leased, or improved by the QOZB is treated as QOZB.

If a QOZB receives multiple overlapping or sequential infusions of working capital that satisfy the working capital safe harbor in connection with tangible property, and if the initial and subsequent working capital infusions form an integral part of the plan covered by the initial working capital infusion, the 31-month period for the initial working capital infusion can be extended for another 31 months (for a total of 62 months).

## **CONSOLIDATED RETURN RULES GUIDANCE**

The Final Regulations also make taxpayer-friendly changes to the Proposed Regulations' application of the QOZ rules in the concept of consolidated return groups. The Proposed Regulations provide that the member that recognizes capital gain must be the member that rolls over the gain to a QOF, and that stock of a corporation that is a QOF is not treated as stock for purposes of determining whether the corporation is a member of the consolidated group. Thus, although a corporate QOF can be the parent of a consolidated return group, a corporate QOF cannot otherwise be a member of a consolidated return group.

The Final Regulations provide relief in both of these situations. First the Final Regulations allow an election by a consolidated group to treat an investment in a corporate QOF by one group member as a qualifying investment by another group member. Second, subject to certain requirements, a corporate QOF may be a subsidiary member of a consolidated return group, and the Final Regulations provide detailed rules to coordinate the QOZ rules and the consolidated return rules.

## GENERAL ANTI-ABUSE RULE GUIDANCE

The Final Regulations provide some anti-abuse rules. The IRS is permitted to recast a transaction or series of transactions as necessary to achieve the goals of the QOZ rules and to present tax results that are inconsistent with the goals of the QOZ program based on all relevant facts and circumstances. The Final Regulations also provide that a partnership cannot be used to achieve results not otherwise available.

## UNRESOLVED ISSUES AND QUESTIONS NOT YET ANSWERED

The Final Regulations leave many questions unanswered. Among those questions are:

- Can a QOZB with a largely mobile work force satisfy the requirement that at least 50% of its gross income is sourced to a QOZ?
- Are improvements made to nonqualified property (*e.g.*, property purchased by a QOF or QOZB before December 31, 2017, from a related person, or other than by purchase) original use property?
- What constitutes reasonable cause for failing to qualify as a QOF?
- How will the substantial improvement requirements apply in the context of the acquisition of the assets of an operating business by a QOZB?
- What additional information will the IRS require from a QOF concerning its investments?

If you have any questions about investing in or forming and operating a QOF or QOZB, please contact any member of [Ballard Spahr's QOZ team](#).

Members of Ballard Spahr's QOZ Team will present a [seminar/webinar on QOZs](#) addressing the Final Regulations on January 31, 2020, at 3:00 pm ET.

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