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CHAPTER 7

Qualified Opportunity Zones—OZ Primer and Selected 2022 OZ Hot Topics

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Synopsis

§ 7.01 INTRODUCTION
[1] What We Are Covering
[2] Selected "Hot Topics" Covered
[a] Working Capital Safe Harbor Items
[b] Early Dispositions Cause Full Recognition of Post-Acquisition Gain
[c] Carried Interest and Crystallization Items
[d] Legislative Proposals
§ 7.02 QUALIFIED OPPORTUNITY ZONES: A PRIMER
[1] Overview
[2] U.S. Federal Tax Benefits of Qualified Opportunity Zone Investments
[a] Capital Gain Deferral
[b] Reduced Tax on Deferred Capital Gain for QOF Investments Pre-December 31, 2021

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[c] Elimination of Tax on Future Capital Gains

[3] Contributed QOZ Funds

[a] Overview

[b] 180-Day Period to Invest Requirement

[c] Investor's Basis in QOF Investment

[4] QOF Deployment

[5] Qualified Opportunity Zone Property & Qualified Opportunity Zone Business Property

[a] QOZ Stock and QOZ Partnership Interests (QOZBs) / Working Capital Safe Harbor

[b] QOZB Property

[6] Original Use vs. Substantial Improvement of Existing Property

[7] Debt Distributions

§ 7.03 WORKING CAPITAL SAFE HARBOR CONSIDERATIONS

[1] Overview

[2] Complying with the Three Working Capital Safe Harbor Requirements

[a] Types of Expenditures

[b] Other Written Plan Items

[3] Extending the Working Capital Safe Harbor Beyond 31-Months

[a] Extensions for Governmental Delays

[b] Extensions for Federally Declared Disasters

[c] Extensions for Multiple WCSHs

[4] Effect of the Working Capital Safe Harbor on QOZB Requirements

[5] Suspension of the 70% Tangible Property Requirement for Start-Up Businesses

§ 7.04 EARLY DISPOSITION OF QUALIFIED OPPORTUNITY ZONE INVESTMENTS

[1] Overview

[2] Post-Acquisition Gains Recognized Despite Reinvestment

[3] Early Sale Without 1031 Exchange

[4] Early Sale With a 1031 Exchange

[5] Early Disposition: Combining Section 1202 & QOZ Program Benefits

§ 7.05 CARRIED INTEREST & CRYSTALLIZATION OPTIONS FOR QOZ INVESTMENTS

[1] Carried Interest

[2] Crystallization and Value Generation

[3] Payout Options

[4] Crystallization Pitfalls

[a] Start-Up Stage
[b] At Crystallization
§ 7.06 PROPOSED LEGISLATION IN THE QUALIFIED OPPORTUNITY ZONE CONTEXT
[1] Possible Changes
[2] 2020 Biden QOZ Proposals
[3] QOZ Bills Since 2019
§ 7.07 CONCLUSION

§ 7.01 INTRODUCTION

[1] What We Are Covering

The first half of this Article [*Section 7.02*] is a primer describing the rules applicable to "qualified opportunity zone" ("**QOZ**") investments that were contained in the three sets of intricate and taxpayer-friendly Treasury Regulations that the industry has been working with during the four years since the statutory incentives for QOZ investments first took effect in 2018 (the "**QOZ Rules**").

The second half of this Article [*Sections 7.03 et seq.*] discusses some of the hot topics that practitioners are experiencing in 2022 when structuring "qualified opportunity zone business" ("**QOZB**") joint ventures for the development of real estate and operating businesses under the QOZ Rules. The reader should proceed directly to the hot topic discussion [*Sections 7.03 et seq.*] if the reader already has a general understanding of the QOZ Rules.

This Article begins *[Part 7.02]* with a general overview of the QOZ Rules provided under the Internal Revenue Code of 1986, as amended (the "**Code**") and related Treasury Regulations promulgated thereunder.

Sections 7.03 et seq. cover the following selected "hot topics" that are of general interest today to those structuring QOFs and investments in QOZB joint ventures between QOFs and third-party developers.

[2] Selected "Hot Topics" Covered

[a] Working Capital Safe Harbor Items

The first hot topics covered involve compliance with the "working capital safe harbor" ("**WCSH**")—the welcome safe harbor for "reasonable reserves" that allows the deployment of QOZ funds for up to 62 months to complete development. Section 7.03 discusses the following:

(i) **Written Plan Amendments**—the ability of the QOZB to amend its WCSH plan(s) as the actual business plan develops and evolves, and demonstrating a commercially justifiable business purpose for such amendments [*see Section 7.03[2][b]*];

(ii) **Sequential Plans to 62 Months**—if the QOZB actually needs time to get its business or property up and running in an active trade or business, how to plan ahead to utilize the maximum aggregate 62-months of the WCSH period through sequential or overlapping WCSH plans so that the QOZB can delay its need to satisfy the many QOZB testing requirements [*see Section 7.03[3]*];

(iii) **Tracking Delays for 24-month Extension**—the need for a QOZB to keep track of the delays caused by the Federally declared COVID disaster and/or any project-specific government caused delays so that it can identify whether and to what extent it may be eligible for the additional 24-month WCSH extension (which would extend the maximum aggregate WCSH period for start-up businesses to an outer limit of 86-months, assuming the QOZB can show cause for such additional extension [*see Section 7.03[3]*]; and

(iv) **Delayed 70% Tangible Property Testing**—qualifying for delayed testing for a "start-up" QOZB, enabling a QOZB having "bad" tangible property (such as property purchased prior to 2018, property purchased from a related party, or contributed property) to satisfy the 70% tangible property requirement while its valid WCSH plan(s) are in effect [*see Section 7.03[5]*].

[b] Early Dispositions Cause Full Recognition of Post-Acquisition Gain

Despite the 12-month reinvestment rule for early dispositions prior to 10 years, all sales prior to 10 years cause recognition of post-acquisition gain of a QOF, even if ALL of the proceeds are reinvested in a new QOZ property within the permitted 12-month period. The only exceptions are:

(i) **1031 Exception**—a Section 1031 transaction (closing within the 180-day Section 1031 period) into a new qualifying QOF investment in a QOZ *[see Section 7.04[4]]* and

(ii) **1202 Exception**—potential additional options in the context of the sale of Section 1202 "qualified small business stock" [*see Section 7.04[5]*].

[c] Carried Interest and Crystallization Items

With respect to crystallizing a developer's carried interest in a QOZ investment:

(i) **Non-qualifying QOF Interest of QOF**—if the QOF is the recipient of carried interest in a QOZB (or is otherwise treated as purchasing the operating partner's share of its crystallized carry), such carried interest will be treated as a non-qualifying investment by the QOF [*see Section 7.05[3]*];

(ii) **Carried Interest of Developer**—if a non-QOF investor is the recipient of carried interest in a QOZB (such as a taxable developer), such carried interest is not eligible for any QOZ tax incentive benefits in the QOZB joint venture [*see Section 7.05[3]*]; and

(iii) **Keeping QOZB Alive**—the QOF will lose flexibility if the QOZB terminates [*see Section 7.05[4]*].

[d] Legislative Proposals

The various legislative proposals affecting QOZs and what types of changes are most likely to make it into future QOZ law are discussed in Section 7.06.

§ 7.02 QUALIFIED OPPORTUNITY ZONES: A PRIMER

[1] Overview

Before delving into the hot topics in QOZ practice [*Sections 7.03 et. seq.*], it is important (1) to have a primer as to the QOZ Rules and (2) to understand the various rounds of legislation and Treasury Regulations that govern QOZ investments. On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the "**TCJA**") was signed into law. The TCJA included the provisions of Sections 1400Z-1 and 1400Z-2 of the Code, establishing QOZs and QOFs for tax advantaged investment in targeted communities. Section 1400Z-1 of the Code provides the method of designation and certification of QOZs. Governors and CEOs of territories and the District of Columbia were able to designate (nominate) certain qualifying low-income communities as QOZs with certification of such designations by the Treasury Department. As of July 9, 2018, all QOZs were certified by the Treasury Department, with a final total of 8,764 QOZs. Section 1400Z-2 establishes certain tax advantages for a qualifying investment made through a QOF that invests in property or businesses located in QOZs.

It took over 10 months from enactment of the QOZ provisions of Section 1400Z, for the IRS to release the first set of proposed regulations providing guidance on its interpretation of the rules governing QOFs on October 19, 2018 (the "**Initial Proposed Regulations**"). On April 17, 2019, the IRS released a second set of proposed regulations (together with the Initial Proposed Regulations, the "**Proposed Regulations**") and on December 19, 2019, the IRS released the final set of regulations (the "**Final Regulations**") that amplify and clarify the Proposed Regulations. The IRS issued corrections to the Final Regulations on April 1, 2020 and August 4, 2021 (the Final Regulations, as so corrected, are referred to as the "**OZ Regulations**"). The Final Regulations generally apply for taxable years beginning after March 13, 2020. While the OZ Regulations provide guidance on most issues, there are some questions involving the QOZ Rules that practitioners hope will be clarified by further U.S. Department of Treasury Regulations and rules and guidance from the Treasury Department and the IRS.

The QOZ tax incentive program provides significant planning opportunities for many investors and creates opportunities for long-term investment in areas most needing redevelopment, revitalization, and business growth. Qualified commercial property, businesses, and projects may use this program as a low-cost subsidy for growth.

[2] U.S. Federal Tax Benefits of Qualified Opportunity Zone Investments

[a] Capital Gain Deferral

QOZ investments offer **three major tax incentives**:

(i) capital gain deferral until December 31, 2026,

(ii) reduced tax on deferred capital gain *for capital gains invested in a QOF prior to January 1, 2022*, and

(iii) elimination of tax on future capital gains and depreciation recapture if the interest in the QOF is held for 10 years.

Investors in all states receive the federal QOZ investment benefits. While many states do not have state level taxation (e.g., Florida), others fully allow the federal incentives to apply for state level taxes (e.g., Texas), some states only partially allow the federal incentives to apply for state level taxes (e.g., New York), and others have de-coupled completely and do not currently allow the federal incentives to apply for state level taxes (e.g., California). The state and local rules are a changing landscape, and because investors in states that do not conform to the federal treatment (like California) will not receive deferral or basis step-up for state and local tax purposes, ***it is important that each potential QOZ investor consult his or her own tax advisors regarding the tax treatment of such investor's QOZ investment***.

At the election of the taxpayer who reinvests eligible gains (short-term or long-term capital gains from recognition transactions with unrelated persons) timely in a QOF, such taxpayer may defer the recognition of capital gains ("**Deferred Gain**") resulting from a sale or exchange of property (including stocks, equity interests, real estate, etc.) by such taxpayer until the earlier of (a) a disposition of the investment in such QOF or (b) December 31, 2026.[1] To qualify, the gains must generally be contributed to a QOF within 180 days of the realization of the gain by the investor.[2] However, for certain investors receiving eligible gains from pass-through vehicles, such 180-day period may commence at the election of the taxpayer on (i) the date the gain was realized by the pass-through vehicle, (ii) the last day of the pass-through vehicle's taxable year in

[1] I.R.C. § 1400Z-2(b)(1).

[2] § 1400Z-2(a).

which the gain was realized, or (iii) the due date for the pass-through vehicle's tax return for the year in which the entity realized the gain, without extensions.[3]

A taxpayer defers gain, in whole or in part, by making an election on its Federal income tax return for the taxable year in which the gain would be included if not deferred.[4] Such taxpayer will report a deferral election on Form 8949, *Sales and Other Dispositions of Capital Assets*, filed with Schedule D.[5] Additionally, Form 8997, *Initial and Annual Statement of Qualified Opportunity Fund Investments*, must be filed by every taxpayer who owns, or owned, a QOF investment during the taxable year.[6] This form requires disclosure of:

(i) total QOF investment holdings due to deferrals prior to beginning of the tax year,

(ii) current tax year capital gains deferred by investing in a QOF,

(iii) QOF investments for which gain is included during the current tax year, and

(iv) total QOF investment holdings at year end due to deferrals.[7]

If a taxpayer fails to report this information, there is a rebuttable presumption that the taxpayer had an inclusion event during that year.[8] The taxpayer is able to rebut this presumption by (1) filing the required report with respect to the qualifying investment held during the year or (2) establishing to the satisfaction of the Commissioner that an inclusion event did not occur.[9] Both Form 8949 and Form 8997 should be filed with the taxpayer's regular timely filed tax return on such tax return's due date, including extensions.

[b] Reduced Tax on Deferred Capital Gain for QOF Investments Pre-December 31, 2021[10]

If an investment is maintained in the QOF for five years prior to December 31, 2026 (the "**Recognition Date**"), the taxpayer will receive a step-up in the tax basis of its

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[3] Treas. Reg. § 1.1400Z2(a)-1(c)(8)(iii). Analogous rules apply to other pass-through entities such as S corporations, non-grantor trusts and decedent estates, but the remainder of this discussion will refer only to capital gains realized by partnerships (including limited liability companies classified as partnerships). Treas. Reg. § 1.1400Z2(a)-1(c)(9).

[4] Treas. Reg. § 1.1400Z2(a)-1(a)(2).

[5] IRS Form 8949, "*Sales and Other Dispositions of Capital Assets.*"

[6] IRS Form 8997, "*Initial and Annual Statement of Qualified Opportunity Fund Investments*."

[7] Id.

[8] Treas. Reg. § 1.1400Z2(a)-1(d)(2).

[9] Treas. Reg. § 1.1400Z2(a)-1(d)(2).

[10] Although expired, the authors understand that extender legislation may be introduced to extend and reinstate this benefit to investments of Deferred Gain in QOFs after December 31, 2021. Hence, the

partnership interest equal to 10% of the original Deferred Gain for eligible investments made in a QOF prior to January 1, 2022.[11] If an investment is maintained in the QOF for seven years prior to the Recognition Date, the taxpayer would receive an additional 5% step-up in the tax basis of its partnership interest (for a total reduction in the original Deferred Gain of 15% for investments in QOFs made prior to December 31, 2019).[12]

Deferred Gain is Recognized on December 31, 2026. *A recognition event will occur on December 31, 2026 (or upon the investor's earlier sale of the investment in the QOF or other "inclusion event") generally in the amount of the lesser of (a) the remaining Deferred Gain (after reduction by earned basis step-ups) or (b) the fair market value of the investment in the QOF (after reduction by earned basis step-ups).*[13] The fair market value amount protects investors against taxation on investments that have lost value. *The Deferred Gain recognized in 2026 will be taxable at applicable rates in 2026.*[14] When the Deferred Gain is recognized, the investor may increase the basis of its interest in the QOF by the amount of gain recognized.[15] The Deferred Gain will retain its character (e.g., short-term or long-term capital gain) as when first realized by the investor.[16]

[c] Elimination of Tax on Future Capital Gains

If an investment is held in a QOF for at least 10 years, at the election of the investor, all post-acquisition appreciation from the date of investment in the QOF may be excluded permanently from gross income upon a sale or exchange of the partnership interest in the QOF.[17] This exclusion from income will apply for federal income tax purposes and for any state taxes that follow the federal regime. This occurs because the basis in the investment in the QOF is stepped-up to the fair market value of the investment in the QOF upon a sale or exchange of the investment in the QOF after a 10-year holding period.[18] *The step-up also eliminates the tax on depreciation recapture.* Additionally, an investor can elect to exclude from gross income all gains and losses

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discussion of the reduced tax has been included here despite the benefit being expired. *See Section 7.06, infra.*

[11] I.R.C. § 1400Z-2(b)(2)(B)(iii).

[12] § 1400Z-2(b)(2)(B)(iv). The additional 5% step up in basis is only available for investments made in a QOF prior to January 1, 2020 and the 10% step up in basis is only available for investments made in a QOF prior to January 1, 2022.

[13] § 1400Z-2(b)(2)(A).

[14] Treas. Reg. § 1.1400Z2(a)-1(c)(1)(ii).

[15] § 1400Z-2(b)(2)(B).

[16] Treas. Reg. § 1.1400Z2(a)-1(c)(1)(i).

[17] § 1400Z-2(c).

[18] § 1400Z-2(c).

allocated to the investor from the direct or indirect sale of property or properties by the QOF or any partnership that is owned by the QOF, such as a QOZB.[19] Thus, the exclusion of gain is allowed whether an investor sells its interest in the QOF, the QOF sells its assets (i.e., its partnership interest in the QOZB), or the QOZB directly or indirectly sells its assets (except for inventory sold in the ordinary course of business).

[3] Contributed QOZ Funds

[a] Overview

An eligible entity (defined as an entity that is classified as a partnership or corporation for federal income tax purposes) is able to "self-certify" as a QOF by annually filing a self-certification on Form 8996, *Qualified Opportunity Fund*, and attaching the form to its timely[20] filed federal income tax return (including extensions) for the taxable year.[21] Such entity does not need to go through any specific approval process in order to be considered a QOF. This same form is also used to annually report the QOF's compliance with the 90% Asset Test (discussed *infra*).

In order for an investor's capital contribution to a QOF to qualify for the benefits discussed above, the investor must invest gains from a sale or exchange of property.[22] The "gain" must be a gain that is treated as a capital gain, whether short-term or long-term.[23] Code Section 1231 gains of an investor ("**Section 1231 Gains**")[24] are eligible gains but only to the extent such gain exceeds any amount that is treated as ordinary income under the depreciation recapture rules of Section 1245 and 1250 of the Code.[25] Section 1231 Gains are eligible regardless of whether those gains are finally determined to be capital or ordinary pursuant to the netting process required under Code Section 1231(a).[26] Deferrable gain may also include unrecaptured section 1250 gain.[27]

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[19] § 1400Z-2(c); Treas. Reg. § 1.1400Z2(c)-1.

[20] The IRS may grant an extension of time to file Form 8996, pursuant to Treas. Reg. § 301.9100-1, if the IRS finds that a taxpayer acted reasonably and in good faith, and if granting relief will not prejudice the interests of the government.

[21] Treas. Reg. § 1.1400Z2(d)-1(a)(2)(i). IRS Form 8996, "*Qualified Opportunity Fund*."

[22] Treas. Reg. § 1.1400Z2(a)-1(b)(11).

[23] Treas. Reg. § 1.1400Z2(a)-1(b)(11).

[24] "***Section 1231 Gains***" are recognized gains from the sale or exchange of (i) depreciable property used in a trade or business or (ii) real property used in a trade or business, in each case if the property was held for more than one year. This generally includes residential or commercial rental property held for more than one year.

[25] Treas. Reg. § 1.1400Z2(a)-1(b)(11).

[26] Treas. Reg. § 1.1400Z2(a)-1(b)(11).

[27] Treas. Reg. § 1.1400Z2(a)-1(b)(11).

Ineligible Gains. Subject to certain exceptions, eligible gain does not include (a) gain from a Section 1256 contract, as defined in Code Section 1256(b), (b) gain from a position that was part of a straddle, as defined in Code Section 1092, during the taxable year, or (c) gain from a position that was part of a straddle in a previous taxable year if, under Code Section 1092(a)(1)(B), a loss from any position in that straddle is treated as sustained (subject to the limitations of Code Section 1092(a)(1)(A)) during the taxable year.[28] The investment of a capital gain in a QOF is prohibited if such capital gain is derived from the sale of property by the taxpayer to such QOF (or its interest in the QOZB).[29] Although an investor may acquire a QOF interest by purchase from an existing partner, such acquisition will only get QOZ tax-advantaged treatment if acquired with eligible gains.[30] The amount of the investor's qualifying investment will be equal to the purchase price of the QOF interest.[31]

[b] 180-Day[32] Period to Invest Requirement

Realized gains from a sale or exchange of property must be invested by the same taxpayer deriving the gain.[33] If a capital gain is realized by a partnership,[34] initially, the partnership has the right to reinvest some or all of the gain from the sale of its assets.[35] If and to the extent that the partnership does not elect to reinvest gains, each separate partner of that partnership may choose to reinvest some or all of the gain that was allocated to him or her.[36] If a partner elects to reinvest the gain allocated to such partner, generally such partner must invest the cash in a QOF within 180 days beginning on the last day of the partnership's taxable year in which the gain was realized.[37] However, the partner may choose instead to invest the cash in a QOF within 180 days beginning on (i) the date the gain was realized by the partnership or (ii) the due date for the partnership's tax return for the year in which the partnership realized the gain, without

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[28] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(vi).

[29] I.R.C. §§ 1400Z-2(d)(2), 179(d)(2).

[30] Treas. Reg. § 1.1400Z2(a)-1(c)(5)(iii).

[31] Treas. Reg. § 1.1400Z2(a)-1(c)(6).

[32] The 180-day period is ***inclusive*** of the first day. And as a best practice, if the conclusion of the 180-day period falls on a holiday or weekend, investors should invest prior to such holiday or weekend given the lack of express guidance on this issue.

[33] § 1400Z-2(a)(1).

[34] The term "partnership" should be read throughout to include a limited liability company treated as a partnership for tax purposes.

[35] Treas. Reg. § 1.1400Z2(a)-1(c)(7).

[36] Treas. Reg. § 1.1400Z2(a)-1(c)(8).

[37] Treas. Reg. § 1.1400Z2(a)-1(c)(8)(iii).

extensions.[38] In addition, the same 180-day periods apply for reinvesting Section 1231 Gains as apply to any other capital gains.[39]

[c] Investor's Basis in QOF Investment

When an investor invests cash into a QOF equal to the investor's Deferred Gain, the investor's initial tax basis for the contribution starts at zero, and is then subject to basis increases after the investor has recognized the remaining Deferred Gain in 2026.[40] Partners in a QOF partnership should receive conventional basis adjustments for pass-through allocations of profits and losses and sharing of partnership liabilities under Subchapter K of the Code.[41] Traditional increases to the basis of a partner's interest will be made in connection with borrowings by the QOF or a QOZB, and a partner's share of those basis increases are not treated as a separate investment of cash in the QOF.[42]

[4] QOF Deployment

After the year of certification of a QOF, every QOF will be measured semi-annually to verify that the QOF holds at least 90% of its assets in QOZ Property (defined below), determined by the average percentage of QOZ Property on each measuring date (the "**90% Asset Test**").[43] The testing dates for a QOF's first year are (a) the last day of the first 6-month period composed entirely of months which are within the taxable year and during which the entity is a QOF (assuming a calendar year partnership's first month as a QOF occurs before July) and (b) on the last day of the taxable year of the QOF.[44] Thereafter, the testing dates are semi-annual (e.g., the end of June and December for calendar year QOF partnerships).[45]

The value of a QOF's assets generally may be determined at the QOF's election either (a) by reference to the values shown on the QOF's "applicable financial statement" or (b) by the unadjusted cost of each of its assets.[46] An applicable financial

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[38] Treas. Reg. § 1.1400Z2(a)-1(c)(8)(iii)(B). Analogous rules apply to other pass-through entities such as S corporations, non-grantor trusts and decedent estates, but the remainder of this discussion will refer only to capital gains realized by partnerships (including limited liability companies classified as partnerships). Treas. Reg. § 1.1400Z2(a)-1(c)(9).

[39] Treas. Reg. §§ 1.1400Z2(a)-1(b)(7), 1.1400Z2(a)-1(b)(11)(iii)(B).

[40] I.R.C. § 1400Z-2(b)(2)(B). If the investor invested prior to January 1, 2020 or January 1, 2022 and held its interest for 7 or 5 years respectively, such investor will also receive an applicable 5% and 10% step-up in its tax basis.

[41] Treas. Reg. § 1.1400Z2(b)-1(g)(4)(i).

[42] Treas. Reg. § 1.1400Z2(b)-1(g)(4)(i).

[43] § 1400Z-2(d)(1).

[44] § 1400Z-2(d)(1).

[45] § 1400Z-2(d)(1).

[46] Treas. Reg. § 1.1400Z2(d)-1(b)(2)(i)(A).

statement is defined as the entity's primary financial statement that is either (a) required to be filed with the U.S. Securities and Exchange Commission or (b) a certified financial statement prepared in accordance with generally accepted accounting principles that meets the following standards: (i) such financial statement is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment or is provided for other substantial non-tax purposes, (ii) the entity reasonably anticipates that such financial statement will be directly relied on, and (iii) such financial statement contains valuations, the entity makes significant use of the financial statement values in most of the financial and commercial oversight of its business and that use is related to the management of all or substantially all of the entity's business.[47] *For purposes of determining compliance with the 90% Asset Test at a measurement date, a QOF may exclude all capital contributions received in the prior six months so long as such capital is held in cash or permitted short-term debt*.[48]

[5] Qualified Opportunity Zone Property & Qualified Opportunity Zone Business Property

[a] QOZ Stock and QOZ Partnership Interests (QOZBs) / Working Capital Safe Harbor

As discussed above, QOFs must hold at least 90% of their assets in QOZ Property. QOZ Property includes (a) QOZ Stock, (b) QOZ Partnership Interests, and (c) direct investment and ownership by a QOF of QOZB Property (defined below).[49]

To qualify as "QOZ Stock" or a "QOZ Partnership Interest":

(a) such stock or partnership interest must be acquired by the QOF after December 31, 2017 solely in exchange for cash[50] (and in the case of QOZ Stock, such shares must be from the original issuance of the corporation);

(b) at the time of the issuance of the QOZ Stock or QOZ Partnership Interest, the corporation or partnership must be a QOZB or organized for the purpose of being a QOZB; and

(c) during "substantially all" of the QOF's holding period of the QOZ

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[47] Treas. Reg. §§ 1.475(a)-4(h)(2), 1.1400Z2(d)-1(b)(3).

[48] Treas. Reg. § 1.1400Z2(d)-1(b)(2)(i)(B).

[49] § 1400Z-2(d)(2).

[50] Practitioners debate as to whether *any* portion of an investment not exchanged solely in exchange for cash disqualifies *all or only a portion* of the investment for purposes of the 90% investment test. Although the better answer is that only a portion is tainted, the QOF accountant should be consulted to determine the accountant's position.

Stock or QOZ Partnership Interest, the corporation or partnership must be qualified as a QOZB.[51]

The "substantially all" requirement in clause (c) above means that the corporation or partnership must be qualified as a QOZB for at least 90% of the QOF's holding period of the QOZ Stock or QOZ Partnership Interest.[52] This determination is made on a semi-annual basis based on the cumulative amount of time the QOF owned the QOZ Stock or QOZ Partnership Interest in the QOZB.[53] For example, if a QOF acquires a QOZ Partnership Interest and the QOZB ceases to meet one of the QOZB requirements, the QOF will soon fail to satisfy the requirement that it hold a qualifying QOZ Partnership Interest for 90% of its holding period. To address this concern, the OZ Regulations add a one-time right to cure a violation of the holding period requirement and avoid penalties by actually curing the QOZB's defect within six months if the violation is actually cured by the conclusion of the six months.[54] If the QOF fails to cure the defect within six months, penalties will apply, including during the six-month cure period.[55] A QOF is able to take advantage of the cure period once for each QOZB in which it is invested.[56]

QOZB Requirements. If a QOF invests through a QOZ Partnership Interest or QOZ Stock, the partnership or corporation must constitute a QOZB. Pursuant to the Code, *a QOZB means a "trade or business":*

(i) in which substantially all of the tangible property owned or leased by the partnership or corporation is QOZB Property (defined below),

(ii) from which at least 50% of the gross income of the partnership or corporation for such year is derived from the active conduct of the trade or business of the entity in the QOZ,

(iii) a substantial portion (at least 40%) of the intangible property of the partnership or corporation is used in the active conduct of the trade or business of the entity in the QOZ,[57]

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[51] §§ 1400Z-2(d)(2)(B), (C).

[52] Treas. Reg. §§ 1.1400Z2(a)-1(b)(5), 1.1400Z2(d)-1(c)(3)(i)(C), 1.1400Z2(d)-1(c)(2)(i)(C).

[53] Treas. Reg. §§ 1.1400Z2(d)-1(c)(3)(i)(C), 1.1400Z2(d)-1(c)(2)(i)(C).

[54] Treas. Reg. § 1.1400Z2(d)-1(d)(6).

[55] § 1400Z-2(f); Treas. Reg. § 1.1400Z2(d)-1(d)(6)(iii).

[56] § 1400Z-2(f); Treas. Reg. § 1.1400Z2(d)-1(d)(6)(iii).

[57] The OZ Regulations clarify that intangible property will be deemed to be used in the active conduct of the trade or business in a QOZ if (i) the use is normal or customary in the conduct of the trade or business, and (ii) the intangible property is used in the QOZ in the performance of an activity that contributes to the generation of gross income for the business.

(iv) less than 5% of the average aggregate unadjusted basis of the property of such partnership or corporation for such year is attributable to "***nonqualified financial property***" ("**NQFP**"), and

(v) where no portion of the trade or business includes 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.[58]

The measure of "***substantially all***" is particularly important for businesses with operations and assets in multiple locations (census tracts), both qualifying and nonqualifying as QOZs. The requirement that "***substantially all***" of the tangible property owned or leased by the partnership or corporation be QOZB Property (defined below) means that ***at least 70% of the partnership's or corporation's tangible property must be QOZB Property (defined below)***.[59] The value of QOZB Property (defined below) that is owned by the QOZB is determined at the QOF's election (a) by reference to the values shown on the partnership's or corporation's "applicable financial statement" or (b) by the unadjusted cost of each of its assets.[60]

Property Partially in a QOZ. For a QOZB with a business that operates partly within and partly outside a QOZ, the real property located outside the QOZ will be considered located within the QOZ (for purposes of the requirement that at least 50% of a QOZB's gross income be derived in a QOZ and the requirement that at least 70% of the use of property is within a QOZ) if: (i) the portion of the real property located outside a QOZ is contiguous[61] to real property located within a QOZ; and (ii) the amount of the real property located within the QOZ is "substantial" compared to the amount of the real property located outside the QOZ.[62] The property located within the QOZ should be considered "substantial" if either (a) the unadjusted cost of the real property inside the QOZ is greater than the unadjusted cost of real property outside the

[58] § 1400Z-2(d)(3). In this regard, the OZ Regulations allow up to 5% of its net rentable square feet to be leased to a business of the type mentioned in clause (e) so long as less than 5% of the gross income of the business is attributable to a business of the type mentioned in clause (e).

[59] Treas. Reg. § 1.1400Z2(d)-1(d)(2). The issue of how the Working Capital Safe Harbor impacts application of the 70% tangible property standard is discussed in Section 7.03, Working Capital Safe Harbor Considerations, *infra*.

[60] Treas. Reg. § 1.1400Z2(d)-1(b)(1).

[61] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(viii)(F). Parcels of land are contiguous if they possess common boundaries, or would be contiguous but for the interposition of a road, street, railroad, stream or similar property. Parcels that touch only at a common corner are not considered contiguous.

[62] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(viii).

QOZ, or (b) the amount of the real property based on square footage located within the QOZ is greater than the amount of the real property based on square footage located outside the QOZ.[63]

Non-Qualified Financial Property. As set forth above, less than 5% of the average aggregate unadjusted basis of the property of such partnership or corporation for such year must be attributable to NQFP.[64] NQFP means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations; except that NQFP does not include reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.[65]

Working Capital Safe Harbor. The OZ Regulations provide a ***safe harbor*** in which ***working-capital assets are deemed to be reasonable if certain conditions are satisfied*** (the "**Working Capital Safe Harbor** or "**WCSH"**), which will be discussed in greater detail in Section 7.03, "*Working Capital Safe Harbor Considerations*".[66]

[b] QOZB Property

"**QOZB Property**" means tangible property of a QOF if:

(i) such property was acquired by the QOF by purchase after December 31, 2017 *from an unrelated party,*

(ii) the original use of the property is in the QOZ and commences with the QOF or the QOF *substantially improves* the property (hereinafter discussed),

(iii) the property is *used in a trade or business of the QOF* (the OZ Regulations clarified that the ownership of triple net leased property generally does not constitute a trade or business), and

(iv) during substantially all of the QOF's holding period of the property, *substantially all of the use of the property was in a QOZ.*[67]

For purposes of the unrelated party rule of clause (i) in the preceding sentence (and presumably for all QOZ related party rules, although not abundantly clear), the rules in Code Sections 267(b) and 707(b) apply, except the references therein to 50% are changed to 20%.[68] *This means, for example, that two partnerships are related if there*

[63] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(viii)(E).

[64] I.R.C. §§ 1400Z-2(d)(3), 1397C(b)(8).

[65] § 1397C(e). Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iv).

[66] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v). Section 7.03, *infra*.

[67] § 1400Z-2(d)(2)(D).

[68] Treas. Reg. § 1.1400Z2(d)-2(b)(1)(i).

is common ownership of more than 20% of the capital and/or profits interests (combining all profits and capital interests for purposes of the test).

70% Tangible Property Test / Self-Constructed Property. The "***substantially all***" requirement in clause (iv) above means that during at least 90% of the QOF's holding period of the property (which property includes the QOF's interest in the QOZB[69]), at least 70% of the use of the property was in a QOZ.[70] In addition, not only may property be acquired by purchase, but property may be self-constructed by the QOF or QOZB, provided that it is *constructed with the intent to use such property in a trade or business in the QOZ*.[71] The materials and supplies used to construct the property must also be QOZB Property, which can potentially create an issue if a QOZB is self-constructing property and the general contractor and/or subcontractors are related parties with respect to the QOZB.[72] Practitioners may need to evaluate construction contracts and modify typical AIA terms and conditions related to ownership and payment for supplies and materials and payment of sub-contractors. For purposes of applying the 90% Asset Test of a QOF and the 70% tangible property test of a QOZB, self-constructed property will be treated as being acquired on the date when physical work of a significant nature begins.[73] Although this is a facts and circumstances test, the IRS provided a safe harbor whereby the QOF or QOZB may select the acquisition date to be the date on which it paid or incurred more than 10% of the total cost of the property, excluding the cost of land and preliminary activities such as planning, designing and securing financing.[74]

[6] Original Use vs. Substantial Improvement of Existing Property

As mentioned above, in order for property to constitute QOZB Property, ***either***:

(i) ***the original use of the property must begin with the QOF, or***

(ii) ***the QOF must substantially improve the property.***[75]

This means that the QOF cannot simply purchase a building—the QOF must also make substantial improvements to the building. The IRS has issued a ruling (Revenue Ruling 2018-29) that if a QOF purchases land which is improved by a building, neither the land nor the building can satisfy the original use requirement. While this is true in most

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[69] This is why practitioners should verify an entity is a QOZB from *initial* QOF investment.

[70] Treas. Reg. § 1.1400Z2(d)-2(d)(3).

[71] Treas. Reg. § 1.1400Z2(d)-2(b)(1)(iii).

[72] Treas. Reg. § 1.1400Z2(d)-2(b)(1)(iii). In this situation, it is important to make clear in the construction contract and any related sub-contracts that such contractors are at all times acting as agents for the QOZB.

[73] Treas. Reg. § 1.1400Z2(d)-2(b)(1)(iii).

[74] Treas. Reg. § 1.1400Z2(d)-2(b)(1)(iii).

[75] I.R.C. § 1400Z-2(d)(2)(D).

cases, there can be exceptions, for example, demolition of current improvements in the "bad" 30% category with new "original use improvements."

"***Substantial Improvement***" **Test**. Existing property (i.e., property whose use did not commence with the QOF) is subject to a substantial improvement test to qualify as QOZB Property.[76] *The substantial improvement test provides that property shall be treated as substantially improved by a QOF only if, during "any" 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the QOF (or QOZB) exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF (or QOZB)*.[77] Notably, the OZ Regulations and Code specifically refer to "*any* 30-month period beginning after the date of acquisition," making it clear that such measuring period is not limited to the 30-month period beginning on the acquisition date.[78] This broad language is qualified (likely to curtail potential abuse) by another provision of the OZ Regulations which requires an intention to improve acquired land by more than an insubstantial amount "within 30 months after the date of purchase."[79] For this purpose, any cost added to the basis of the property is included in determining if the property is substantially improved, including demolition costs, capitalized development fees, required permit costs, brownfield assessment and remediation costs, site preparation costs, professional fees, and equipment installed in a building, so long as the cost is added to the basis of the improved property.[80]

Multiple Buildings—Aggregation. Generally, the substantial improvement test must be applied using an asset-by-asset approach.[81] However, two or more buildings may be aggregated and treated as one building for the substantial improvement test if either: (a) the buildings are located on a parcel described in a single deed; or (b) the buildings are located on "contiguous" parcels described in separate deeds and (i) each building is or will constitute a trade or business operated exclusively by the QOF or QOZB, (ii) the buildings are operated in coordination with or reliance upon one or both of the businesses (such as a mixed-use facility), and (iii) the buildings share centralized business elements, such as accounting, human resources, information technology, purchasing or legal services.[82] *By treating the buildings as a single asset, the QOZB does not need to double the basis of each building—rather it only needs to make total*

[76] § 1400Z-2(d)(2)(D)(ii); Treas. Reg. § 1.1400Z2(d)-2(b)(4).

[77] § 1400Z-2(d)(2)(D)(ii).

[78] Treas. Reg. § 1.1400Z2(a)-1(b)(1).

[79] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv)(C).

[80] Preamble to the OZ Regulations.

[81] § 1400Z-2(d)(2)(D)(ii).

[82] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(v).

improvements equal to the combined basis of the aggregated buildings.[83] Moreover, the cost of purchased property that would otherwise qualify as QOZB Property may be taken into account in determining whether additions to the basis of existing property acquired by purchase satisfy the substantial improvement requirement described in this paragraph, so long as the purchased original use property (i) is located in the same QOZ (or a contiguous QOZ) as the property being improved, (ii) is used in the same trade or business as the property being improved, and (iii) improves the functionality of the property being improved.[84]

Land. *Land is not subject to the substantial improvement requirement and will qualify as QOZB Property if the land is used in an active trade or business of the QOF or QOZB*.[85] The OZ Regulations try to distinguish between (x) QOFs or QOZBs that buy unimproved land with the intention of developing the land as part of a business plan, and (y) QOFs or QOZBs that buy unimproved land for speculative investment (land banking) or to conduct a modest business without making a new capital investment in the property.[86] In this regard: (a) there is an anti-abuse rule that is intended to apply where the QOF does not intend to invest new capital or increase the economic growth of the QOZ yet intends to reap the benefits of gain deferral and exclusion; and (b) if a QOF or QOZB purchases unimproved or minimally improved land, such land is subject to the substantial improvement requirement if purchased with the expectation that the QOF or QOZB will not improve the land by more than an insubstantial amount within the 30 months following the purchase.[87] In determining whether the QOZB had such an expectation, land improvements such as grading, clearing, remediation of contamination or acquisition of related QOZB Property that facilitates the use of the land in a trade or business will be taken into account.[88]

Land with Existing Buildings. The IRS has issued guidance with respect to the purchase and improvement of land that is already improved with a building. The OZ Regulations and a separate IRS ruling provide that if a QOF purchases land that is improved by a building, *the "substantial improvement" test is satisfied if the QOF makes improvements to the building that exceed an amount equal to the adjusted basis of the building (i.e., without regard to the basis of the land)*.[89] If the building is so

[83] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(v).

[84] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iii).

[85] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv).

[86] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv)(C).

[87] Treas. Reg. §§ 1.1400Z2(f)-1(c), 1.1400Z2(d)-2(b)(4)(iv)(C).

[88] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv)(C).

[89] Rev. Rul. 2018-29; Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv).

improved, there is no need for the QOF to also improve the land itself.[90] For example, if a taxpayer acquires property worth $100, which is allocated $40 to the land and $60 to the existing improvements, such taxpayer must substantially improve the property by at least an additional $60 (the land is disregarded in the substantial improvement calculation).

Original Use Property. Generally, if the "substantial improvement" test is not met, tangible property acquired by purchase by a QOF or a QOZB must, among other things, meet an "original use" test.[91] The OZ Regulations provide clarity in respect to several of the rules regarding "original use."[92] The "original use" of tangible property begins when the property has been placed in service in the QOZ with respect to depreciation or amortization for tax purposes.[93] In a real estate transaction, "original use" often means ground up development. Neither the original use nor the substantial improvement requirements apply to unimproved land, provided the land is used in an active trade or business.[94] *This means that a QOF may purchase or lease used property which has not been previously depreciated or amortized within a QOZ, and such used property may be considered "original use" property.*[95] *For example, nearly completed projects that have not yet been "placed in service for depreciation purposes" may be acquired by a QOF or QOZB without any need to "double the cost basis" of the existing improvements*. Many investors may be interested in purchasing these assets prior to placement into service to reduce construction risk or "lease-up" risk, and to provide early cash flow opportunities. While these projects are often referred to as "pre-TCO" (standing for "pre-temporary certificate of occupancy), the standard is not "TCO" versus "CO," but rather "in service for depreciation." *Practitioners and professionals must carefully navigate the guidance in this area and diligence a project to verify that such project has not crossed the line to become ineligible for "original use" classification*.

Additionally, a building or facility may be considered "original use" property if, on the date it is purchased by a QOF or QOZB, (a) it was vacant on the date it was designated as being located in a QOZ and has been vacant for at least one uninterrupted calendar year beginning on a date prior to the date of designation, or (b) it was not vacant on the date it was designated as being located in a QOZ, but it has been vacant

[90] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv)(E).

[91] Treas. Reg. § 1.1400Z2(d)-2(b)(3).

[92] Treas. Reg. § 1.1400Z2(d)-2(b)(3).

[93] Treas. Reg. § 1.1400Z2(d)-2(b)(3).

[94] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv).

[95] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(i)(C).

for three uninterrupted calendar years before it is purchased by the QOF or QOZB.[96] A building will be considered vacant for this purpose if 20% or less of the usable space in the building was being used.[97] Further, any real property (land and any structures) that is purchased from a local government that holds the property as a result of an involuntary transfer, such as an abandonment, bankruptcy, foreclosure or receivership, is treated as original use property.[98] *Improvements constructed on leased land (even on land that is leased from a related party) will also satisfy the original use requirement and will be treated as purchased property in an amount equal to the unadjusted basis of such improvements on the leasehold interest*.[99] Finally, if a QOF or QOZB purchases a brownfield site, it may treat all of the land and structures comprising the brownfield site as satisfying the original use test if it makes investments in the site to ensure that all property comprising the brownfield site meets basic safety standards for health and the environment.[100]

[7] Debt Distributions

Generally, distributions may be made to investors in QOFs that are partnerships for tax purposes (but not REITs) without causing an "inclusion event" that triggers the Deferred Gain, but only to the extent the distribution does not exceed the investor's basis in the investor's partnership interest.[101] Investors in multi-asset QOFs may have basis from more than one QOZB, thus allowing for the possibility of distributions covered by sufficient basis to avoid recognition under this rule. Certain nonrecourse financing provides basis for an investor that would permit debt-financed distributions or permit an investor to claim future tax losses.[102] Under this rule, refinancing distributions may be made to investors to pay investor tax on Deferred Gain when deferral ends (in 2026 or at other times). Financing also provides basis for an investor to claim its share of the tax losses of a QOF. The OZ Regulations, however, apply disguised sale principles and presumptions of Section 707 to cash investments in a QOF.[103] For this reason, debt-financed distributions to investors generally will not be possible if there is a refinancing distribution within 24 months of any investor's capital contribution to the QOF without overcoming a disguised sale presumption.

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[96] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(i)(B).

[97] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(iii).

[98] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(v).

[99] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(ii).

[100] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(iv).

[101] Treas. Reg. § 1.1400Z2(b)-1(f)(10).

[102] I.R.C. § 752.

[103] § 707; Treas. Reg. § 1.1400Z2(a)-1(c)(6)(iii)(A)(2).

§ 7.03 WORKING CAPITAL SAFE HARBOR CONSIDERATIONS

[1] Overview

As mentioned in Section 7.02[5][a] above, the OZ Regulations provide a Working Capital Safe Harbor that offers some relief from the strict requirements imposed on QOZBs. Solely for purposes of applying the exception that permits "*reasonable amounts of working capital* held in cash, cash equivalents, or debt instruments with a term of 18 months or less" from the definition of NQFP in evaluating satisfaction of the QOZB requirements, working capital assets are treated as "reasonable" in amount if three requirements are satisfied.[104]

Reasonable Working Capital Requirements—The Written Plan. These three requirements to be "***reasonable working capital***" are:

(i) the amounts are *designated in writing* for the development of a trade or business in a QOZ, including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in a QOZ,

(ii) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets,[105] and

(iii) the working capital assets must actually be used in a manner that is "*substantially consistent*" with the writing and written schedule described in (i) and (ii), above.[106]

Additionally, it is important to realize that the safe harbors discussed herein ***only apply to QOZBs*** and ***do not apply to QOFs***, so most structuring requires two entity levels using both a QOF and a subsidiary QOZB.

[2] Complying with the Three Working Capital Safe Harbor Requirements

[a] Types of Expenditures

In order to take advantage of the WCSH, a *QOZB must prepare and maintain a commercially reasonable written plan(s) for appropriate use in a trade or business of amounts it is claiming are reasonable working capital.* The QOZB also must keep the written plans up-to-date and substantially comply with them so that the entity continues to qualify as a QOZB and so that there is support that the investment in the business

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[104] §§ 1397C(e)(1), 1400Z-2(d)(3)(A); Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v).

[105] The schedule must show consumption of the working capital assets within 31 months of the date on which the business received the assets.

[106] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v).

is in fact QOZ Property. Although these written plans are not filed with the IRS or attached to any tax return form, they should be kept in the books and records of the QOZB as a sound business practice.

The OZ Regulations provide several examples that illustrate the general application of the WCSH.[107] These examples include a variety of types of expenditures that can be in the written plan, such as (i) identifying favorable locations for the QOZB in the QOZ, (ii) leasing suitable space, (iii) outfitting the space with equipment and furniture, (iv) making security deposits, (v) obtaining permits, (vi) hiring and training employees, (vii) performing research and development, and (viii) paying development costs (i.e., acquiring, constructing, or substantially improving tangible property).[108] Other than listing out the expected working capital expenditures, there is no guidance on the required specificity of the written plan.

[b] Other Written Plan Items

Generally, leading practitioners in the industry recommend that such written plans:

(i) state that the specific amount of working capital to which the WCSH applies is designated for the development of the "new business"[109] in one or more QOZs,

(ii) identify the general business plan as it relates to such amounts of working capital, as well as the ultimate finished product of the business,

(iii) include a written schedule that documents the projected expenditures and timeline for incurring such expenditures (with such timeline extending to 31-months or less from the date of receipt of the working capital), and

(iv) identify the QOZ census tract in which the business is located if in a Federally declared disaster (if applicable).

Additionally, to the extent that the written plan is one that is sequential to or overlapping with an earlier written plan, this plan should be sure to include the four items listed above, as well as a consumption schedule that tracks expenditures incurred prior to the subsequent written plan. Finally, since the written plans should be kept up to date, the QOZB may amend its written plans as necessary in response to changes that may arise over time. Such changes to the written plan should be commercially justified so that the IRS cannot make the argument that the QOZB is abusing the WCSH in an effort to bypass the requirement that the QOZB substantially comply with the written plan.

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[107] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vii).

[108] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vii).

[109] Within the meaning of Section 162.

[3] Extending the Working Capital Safe Harbor Beyond 31-Months

[a] Extensions for Governmental Delays

There are three major ways that the WCSH can extend beyond an initial 31 months.

The first possibility of extending the WCSH beyond the prescribed 31-months involves *governmental delays*. If consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure to comply with the substantial compliance requirement of the WCSH.[110] In most situations, applicants can obtain governmental permits through a routine process. The IRS expects a QOZB, to the maximum extent practicable, to take any actions during the governmental permitting period that are necessary for the improvement of tangible property subject to the WCSH.[111] Therefore, with regard to instances in which governmental delay does not pose a substantial obstacle for improving such tangible property, a tolling of the 31-month period would not be appropriate.[112] However, the IRS has determined that the 31-month WCSH should be tolled in certain instances.[113] In general, if a governmental permitting delay has caused the delay of a project covered by the 31-month WCSH, and no other action could be taken to improve the tangible property or complete the project during the permitting process, then the 31-month WCSH will be tolled for a duration equal to the permitting delay.[114]

[b] Extensions for Federally Declared Disasters

The second possibility of extending the WCSH beyond the prescribed 31-months involves *Federally declared disasters*. If a QOZB is located in a QOZ within a Federally declared disaster,[115] the QOZB may receive not more than an additional 24 months to consume its working capital assets as long as it otherwise meets the WCSH requirements outlined above.[116] In response to the COVID-19 Pandemic, the IRS previously released a notice confirming that such a Federally declared disaster existed throughout the entire United States (and thus in all QOZ census tracts) and that any QOZB that held working capital intended to be covered by the WCSH before June 30, 2021 was entitled to receive not more than an additional 24 months to expend its

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[110] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(C).

[111] Preamble to the OZ Regulations. While not an authoritative source, the language in the Preamble does provide some insight into how the Treasury Department and the IRS may approach certain issues.

[112] Preamble to the OZ Regulations.

[113] Preamble to the OZ Regulations.

[114] Preamble to the OZ Regulations.

[115] As such term is defined in I.R.C. § 165(i)(5)(A).

[116] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(D).

working capital, so long as the QOZB otherwise met the requirements of the WCSH.[117] Such notice only applied if and to the extent that QOFs actually invested capital into a QOZB before June 30, 2021.[118] Nevertheless, to the extent the above-mentioned Federally declared disaster is extended, or to the extent that a new Federally declared disaster arises, QOZBs may be eligible for up to an additional 24 months to expend their working capital.[119] Notably, the IRS has unofficially indicated that the additional 24 month extension may not be automatic and QOZBs should be prepared to demonstrate why they need additional time on account of the COVID-19 Pandemic (or by extension, such other Federally declared disaster that may arise in the future).[120] *Practitioners should consult with their tax accountants regarding such extensions to evaluate whether such tax accountants treat the COVID-19 extensions as being automatic or whether they require a showing of cause and attendant documentation.*

[c] Extensions for Multiple WCSHs

The final possibility of extending the WCSH beyond the prescribed 31-months involves the use of *sequential or overlapping WCSHs*. A QOZB may benefit from multiple overlapping or sequential applications of the WCSH, provided that each application is substantial[121] and independently satisfies all the general WCSH requirements.[122] This relief is consistent with the fact that many real estate and other start-up businesses often capitalize their projects in phases, with investors making additional capital contributions or debt draws over time. The key consideration here is that such additional applications must be either overlapping or sequential with the previous WCSH in effect, so it is important to make sure there are no gaps between applications of multiple WCSHs.

62-Month Total. Using subsequent or overlapping applications of the WCSH allows up to a maximum combined total of a 62-month WCSH period for "start-up"[123] QOZBs (or potentially as long as 86 months if such QOZB is also eligible for the extensions provided to those affected by Federally declared disasters).[124] Notably, the potential 62-month WCSH period does not mean that a QOZB has 62 months to consume the original working capital infusion. Instead, a QOZB has 31-months from such original

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[117] Notice 2021-10.

[118] Notice 2021-10.

[119] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(D).

[120] Statement from Christopher Wrobel, special counsel to the Associate Chief Counsel (Income Tax & Accounting) in the IRS Office of Chief Counsel, May 2021.

[121] There is currently no guidance as to what qualifies as "substantial" in this context.

[122] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(E).

[123] There is currently no guidance as to what qualifies as a "start-up" QOZB in this context.

[124] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi)(A).

capital infusion subject to the first WCSH application to consume such specified working capital assets. Then upon each additional substantial infusion of working capital, which is also subject to a new WCSH and independently satisfies the WCSH requirements, the QOZB has an additional 31-months from the date of such additional substantial infusion of working capital to consume such new working capital assets. Also, important to note is the fact that "capital infusion" as used in this discussion may include additional cash contributions *or* certain types of indebtedness.[125] Regarding indebtedness, if the funds are "owned" at the closing of the debt by the borrower, for tax purposes, there is only one infusion at the time of closing of the debt, even if such funds are subject to consent restrictions. Alternatively, funds owned and held with the lender that are merely dispersed upon draws can be considered separate infusions at each draw and subject to a new WCSH if desired.

This process can seemingly be repeated however many times necessary so long as the WCSH requirements continue to be satisfied and until the total WCSH period reaches an outer limit of 62 total months (or 86 months, if applicable). The initial WCSH plan should provide for the use of subsequent capital infusions to the extent that the QOZB expects such infusions. *Because of the ability and need to update the WCSH plan, the plan should be viewed as a "living" document (with the QOF's tax return preparers and QOF consultants closely involved)*.

[4] Effect of the Working Capital Safe Harbor on QOZB Requirements

Use of the WCSH also provides additional safe harbors applicable to a QOZB. Specifically, these additional safe harbors provide relief from the requirements that:

(i) 50% of the gross income of a QOZB be derived in the active conduct of a trade or business in a QOZ (the "**50% Active Business Income Test**"),

(ii) a substantial portion of the intangible property of a QOZB be used in the active conduct of a trade or business in a QOZ,

(iii) at least 70% of the QOZB's tangible property must be QOZB Property, and

(iv) the QOZB is required to be actively conducting a trade or business.[126]

As applied to the 50% Active Business Income Test in (i) above, if ***any*** gross income is derived from property that the WCSH treats as a reasonable amount of working capital, then that gross income is counted toward satisfaction of the 50% Active Business Income Test.[127] As applied to the substantial portion test in (ii) above,

[125] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vii)(D).

[126] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi).

[127] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi)(B).

intangible property purchased or licensed by the QOZB, pursuant to the reasonable written plan with a written schedule for the expenditure of the working capital, satisfies the use requirement during any period in which the QOZB is proceeding in a manner that is substantially consistent with the WCSH. Finally, if the conditions are satisfied for the application of additional sequential or overlapping WCSHs, these additional QOZB safe harbors also apply for the duration of such multiple WCSHs, subject to the 62-month outer limit (or 86-month limit if such QOZB is also eligible for the extensions provided to those businesses that are affected by Federally declared disasters).[128]

[5] Suspension of the 70% Tangible Property Requirement for Start-Up Businesses

If a QOZB is considered a "start-up"[129] *business, the OZ Regulations offer an important exception for QOZBs that suspends the 70% tangible property requirement determination for such QOZB while it has a valid WCSH plan currently in effect.*[130] This exception significantly impacts QOZ deal structures and investment planning for start-up QOZBs. Most notably, in the context of a start-up QOZB with a valid WCSH plan in place, property that is considered "bad property" (i.e., non-QOZB Property) because it is:

(i) property that was purchased prior to 2018,

(ii) property that was purchased from a related party, or

(iii) property that has been contributed to the QOZB,

will not disqualify the QOZB from satisfying the 70% tangible property requirement so long as a valid WCSH plan remains in effect. Further, in the same scenario, the QOF's interest in such QOZB will be considered "good property" (i.e., QOZB Property) for purposes of such QOF's 90% Asset Test.

The effect of this crucially important start-up exception is to broaden the accessibility of the QOZ program. Now, businesses with pre-2018 property, related party property, or contributed property which would otherwise be very limited in their abilities to satisfy the QOZB requirements, have a greater chance of success in the QOZ investment context because they have time to add improvement expenditures under the WCSH plan that cause the "bad property" amount to fall to 30% or less of the total expenditures. However, while helpful, this exception from the 70% tangible property standard is not indefinite. *Rather, the business plan of the QOZB must contemplate how the QOZB will eventually satisfy the 70% tangible property standard, which includes the need for the QOZB to use the property in a trade or business, once the valid WCSH*

[128] Treas. Reg. §§ 1.1400Z2(d)-1(d)(3)(v) and (vi).

[129] The term "***start-up business***" is not defined in the OZ Regulations.

[130] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi)(D)(1).

period(s) have expired and the "bad property" is no longer shielded by such start-up WCSH exception. For example, at the end of the 31-month period (or longer if valid sequential/overlapping WCSH plans are implemented), the value of the contributed, pre-2018, or related party property will be considered non-QOZB Property, and this total cannot exceed 30% of the value of all of the QOZB's tangible property. QOZBs that stand to gain the most from this exception include large real estate development projects where the land or other property is contributed in whole or in part to the QOZB (or purchased from a related party) and the extent of the development is so large that the value of the tangible property at the end of 31 or 62 months will outweigh the beginning value to such an extent that the QOZB theoretically should never need to worry about satisfying the 70% tangible property requirement.

§ 7.04 EARLY DISPOSITION OF QUALIFIED OPPORTUNITY ZONE INVESTMENTS

[1] Overview

In light of currently rising real estate values, a number of QOF sponsors are inquiring about the possibility of disposing of newly developed assets earlier than the required minimum holding period of 10 years after their investors acquired their interests in the QOF with Deferred Gain contributions. Many QOF sponsors incorrectly believe that if they reinvest the proceeds from the sale of a QOZ Property in another QOZ Property within 12 months after the sale of the first QOF investment, they escape gain taxation for their investors.[131] However, despite the apparent benefit afforded by the QOF Rules to reinvest QOF proceeds within 12 months of sale, an early sale prior to 10 years really only works (i) to avoid an inclusion event prior to 2026 with respect to the Deferred Gain (otherwise being recognized on December 31, 2026) and (ii) to continue the 10-year holding period for the taxpayer's initial QOF investment and any post-acquisition appreciation that is reinvested by the QOF in new QOZ Property within the 12-month QOF reinvestment period.[132] *This continuation of the 10-year holding period for the new QOZ Property is a very important benefit (and investors may choose to leave the proceeds in the QOF rather than taking such proceeds out and investing them in a new QOF to shelter the gain, because such new QOF investment would have a new 10-year holding period).* However, QOF investors must note that the tax elimination benefit on post-contribution gain occurring from acquisition until the date of that early sale is lost and the investors will be taxed on all of the post-contribution gain upon such sale. As a result, the investors won't achieve the principal benefit of the QOZ Rules (gain elimination after 10 years) unless the early sale is paired with a Section 1031 transaction into new property located in a QOZ that meets the requirement for QOZB

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[131] Treas. Reg. § 1.1400Z2(f)-1(b)(1).

[132] Treas. Reg. § 1.1400Z2(f)-1(b)(1).

Property and the transaction closes within the 180-day period required for Section 1031 transactions. Otherwise, if there is gain from a sale prior to 10 years, the investors will recognize gain even if the proceeds are reinvested by the QOF within the 12-month QOF reinvestment period.[133] Accordingly, projections must be run to show that the early sale produces a better after-tax benefit than leaving the money in that particular property for 10 years.[134]

[2] Post-Acquisition Gains Recognized Despite Reinvestment

If a QOF, QOZB, or investor sells an asset before the 10-year holding period, there is a 12-month safe harbor to reinvest the cash in new QOZ Property.[135] A QOF (but not a QOZB) that sells an asset but does not distribute the proceeds may hold the proceeds for up to 12 months without such proceeds being treated as non-qualified assets under the 90% Asset Test, so long as the proceeds of the sale are held in cash or permitted short-term debt.[136] Although many sponsors believe that this rule is like Section 1031 where reinvestment means no gain is recognized, this is not the rule for the QOZ 12-month reinvestment safe harbor. In contrast to Section 1031, the OZ Regulations **did not** include a provision that would allow non-recognition treatment for investors upon the sale of QOZ assets despite the reinvestment of all of the proceeds in a QOZ within the 12-month period. Therefore, a sale before the 10-year holding period is met will be a taxable event for the QOF investors, even if the QOF reinvests the interim sales proceeds in new QOZ Property within 12 months from the sale of the original QOZ Property. *The sole benefits of satisfying the 12-month reinvestment rule are: (i) the Deferred Gain continues to be deferred until 2026 and (ii) no new 10-year clock begins for the QOZ investment holding period—but QOF investors will have to pay tax on their share of the gain occurring since the acquisition of the original QOZ Property with their rollover Deferred Gain investments in the QOF.* If the QOF is a partnership or S corporation, the interim gain will be allocated to the partners and shareholders and fully recognized and they will have phantom income tax liability if the QOF does not make a tax distribution to the QOF's partners or members.

[3] Early Sale Without 1031 Exchange

If an early sale occurs within the 10-year period *and a 1031 exchange **does not** occur,* the sponsor has the following choices: (i) reinvest all of the proceeds in QOZ Property within the 12-month period after sale (and leave investors with phantom tax liability),

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[133] As mentioned above, an investor may invest such gain in the same or a different QOF.

[134] The only solution to this gain recognition problem would be for Congress to change the QOF reinvestment provision to be like the 1031 program where the deferral is permitted of ***all*** gain from the sale of a QOF interest if ***all*** of the proceeds are reinvested in a QOZ within 12 months.

[135] Treas. Reg. § 1.1400Z2(f)-1(b)(1).

[136] Treas. Reg. § 1.1400Z2(f)-1(b)(1).

(ii) make tax distributions to QOF partners and reinvest the balance in QOZ Property (i.e., a new QOZB) within the required 12-month period or (iii) distribute all of the proceeds to QOF investors. All of these options take away the key benefit of the QOZ Rules of having zero taxation on the post-acquisition appreciation. This means that the after-tax return of the early sale would have to be high enough to outweigh the loss of this key tax benefit. The fourth option would be to try to do a simultaneous Section 1031 like-kind exchange and 12-month QOZ reinvestment. This is very difficult to achieve but is possible [*see Section 7.04[4], infra*]. The sponsor of the QOF must be sure it has the authority under the governing documents with QOF investors to do an interim sale in light of the loss of the 10-year tax exemption on the post-acquisition gain.

The two benefits of reinvesting the proceeds from the early sale of QOZ Property in another QOZ Property within 12 months of the sale property are: *(i) the Deferred Gain continues to be deferred until 2026 and (ii) no new 10-year clock begins for the QOZ investment holding period—but QOF investors will have to pay tax on their share of the gain occurring since the acquisition of the original QOZ Property with their rollover Deferred Gain investments in the QOF.* If the QOF is a partnership or S corporation, the interim gain will be allocated to the partners and shareholders and fully recognized and they will have phantom income tax liability if the QOF does not make a tax distribution to the QOF's partners or members.

Tax Distributions. Upon an early sale, the QOF might make estimated tax distributions to its investors for the estimated taxes owed as a result of the taxable sale of the QOZ Property and corresponding interim gain recognition allocated to the partners of the QOF. Distributions from a QOF that is classified as a partnership for tax purposes are generally excepted from the rule that distributions of property are considered inclusion events.[137] Under this special rule for partners and partnerships, an actual or deemed partnership distribution allocable to a qualifying investment is only an inclusion event to the extent that the distributed cash or other property has a fair market value in excess of the partner's adjusted basis in the qualifying investment.[138] Thus, as long as the estimated tax distributions from the QOF are not in excess of the partners' respective bases in the partnership, such distributions would not trigger inclusion of the previously Deferred Gain.

Inclusion Events. An actual or deemed partnership distribution allocable to a qualifying investment is an inclusion event to the extent that the distributed cash or other property has a fair market value in excess of the partner's adjusted basis in the

[137] Treas. Reg. §§ 1.1400Z2(b)-1(c)(1)(ii), -1(c)(6).

[138] Treas. Reg. § 1.1400Z2(b)-1(c)(6)(iii).

qualifying investment.[139] If capital gain is properly invested in a QOF, the tax on that gain is deferred until the taxable year that includes the earlier of: (1) the date of an inclusion event; or (2) December 31, 2026.[140] There are several events (in addition to the sale or exchange of all or part of the qualifying investment) that could trigger gain inclusion.[141] Distribution of the entire proceeds from the sale of the QOZ Property would likely be an inclusion event which would trigger recognition of the previously deferred gain. This previously deferred gain is considered eligible gain that can be further deferred through subsequent investment in a QOF.[142] Additionally, the asset sale before the satisfaction of the 10-year holding period will be a taxable event, triggering a new set of eligible gains which can be deferred if used in a new QOF investment.

Gain from Inclusion Events. Gain that a QOF investor would otherwise have to include in gross income as the result of an inclusion event ("**Inclusion Gain**") is eligible for deferral, provided that all of the requirements for electing to defer gain are met.[143] For purposes of determining the applicable 180-day period within which to invest Inclusion Gain, that gain is treated as if it were originally realized upon the occurrence of the inclusion event.[144] Thus, in order for this reinvestment to qualify for QOZ benefits, the investor has to make the new investment in a QOF within 180 days of the date that the investor would otherwise have been required to include the previously deferred gain in income. The holding period for a qualifying investment in a QOF that is attributable to eligible gain arising from an inclusion event begins on the date that the gain is reinvested in a QOF (new 10-year clock begins).[145] In conclusion, if the QOF distributes all interim sales proceeds to investors, and investors make a new investment (using both the previously deferred gain and the new capital gain arising from the sale) in a QOF within 180 days of the date that the taxpayer would otherwise have been required to include such gain in income, then the deferred gain continues to be deferred and the new gain from the sale is also deferred until the earlier of the next inclusion event or December 31, 2026, and a new 10-year clock begins for the entire new QOZ investment.

[4] Early Sale With a 1031 Exchange

A Section 1031 exchange could avoid gain recognition on an early sale. This would be accomplished by finding a new QOZ Property investment that also meets the

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[139] Treas. Reg. § 1.1400Z2(b)-1(c)(6)(iii).

[140] Treas. Reg. § 1.1400Z2(b)-1(b).

[141] *See generally*, Treas. Reg. § 1.1400Z2(b)-1(c).

[142] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(iv)(A).

[143] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(iv)(A); I.R.C. § 1400Z-2(a)(1).

[144] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(iv)(B).

[145] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(iv)(C).

requirements to qualify as a Section 1031 exchange. Section 1031 provides an exception from the general rule requiring the current recognition of gain or loss realized upon the sale or exchange of real property.[146] In a Section 1031 exchange, no gain or loss is recognized if real property held for productive use in a trade or business or for investment is exchanged solely for real property of a like-kind to be held either for productive use in a trade or business or for investment.[147] Generally, the realized gain is deferred until the replacement property is disposed of in a subsequent taxable transaction; however, any realized gain will be recognized to the extent of the sum of the money (including net liabilities assumed or attaching to the property) received and the fair market value of nonqualifying property received (the "**boot**").[148] Gain realized on a Section 1031 exchange must also be recognized to the extent that the gain is subject to recapture provisions under Section 1245 and Section 1250, among other provisions.[149] Notably, the transaction does not need to be tax-free to both parties for Section 1031 to apply—an exchange may be taxable to one party and tax-free to the other.[150]

The Section 1031 exchange also has certain timing requirements that must be considered when planning for the new investment in QOZ Property. The timeline begins from the date that the relinquished property closes (i.e., the sale of the original QOZ Property). From the original QOZ Property closing date, the QOF has *45 days to identify* (through specific identification procedures set out in Treasury Regulations[151]) potential replacement property or properties, which would need to be in a QOZ to continue the original QOZ benefits.[152] Also from the original closing date, the QOF has *180 days to acquire* such replacement property in a QOZ.[153] Once the replacement property has been acquired, the basis of such property is the same as the basis of the property transferred, decreased by the amount of any money received, and increased by the amount of any gain recognized.[154] The holding period of the replacement property received includes the holding period of the qualified property transferred.[155]

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[146] § 1001(c).

[147] § 1031(a)(1).

[148] § 1031(b).

[149] §§ 1245(b)(4), 1250(d)(4).

[150] *See, e.g.*, Rev. Rul. 75-292.

[151] Treas. Reg. § 1.1031(k)-1(c).

[152] § 1031(a)(3)(A).

[153] § 1031(a)(3)(B).

[154] § 1031(d).

[155] § 1223(1).

As a practical matter, it is important to note that while a two-party Section 1031 exchange can be accomplished, such an exchange is often difficult to achieve. However, it is clear that a taxpayer can execute a tax-deferred exchange of its property under Section 1031 through the use of a "three-party" exchange or "four-party" exchange.[156] However, there are situations where a safe harbor cannot be used (or the taxpayer does not wish to incur the additional expense for an unrelated intermediary).

In conclusion, if the QOF identifies potential replacement QOZ Property within 45 days from the sale of the original QOZ Property, the QOF reinvests the interim sale proceeds in replacement QOZ Property within 180 days from the sale of the original QOZ Property (not the longer 12-month period in the QOZ Rules) and such replacement QOZ Property satisfies the various technical requirements for the combined sale and purchase to be considered a valid Section 1031 exchange, then (i) the deferred gain continues to be deferred, (ii) no new 10-year clock begins for the QOZ investment, and (iii) the investors will not pay tax on the gain from the interim sale (unless the Section 1031 exchange included boot in addition to the exchange of like-kind property).

[5] Early Disposition: Combining Section 1202 & QOZ Program Benefits

For taxpayers other than corporations, Section 1202 of the Code excludes from gross income all of the gain recognized on the sale or exchange of qualified small business stock held for more than five years.[157] The gain exclusion is 100% for qualified small business stock acquired after September 27, 2010.[158] A "qualified small business" is defined as any domestic corporation taxed as a C-corporation if (i) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after August 10, 1993 and before the issuance did not exceed $50,000,000, (ii) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed $50,000,000, and (iii) such corporation agrees to submit such reports to the IRS and to shareholders as the IRS may require to carry out the purposes of Section 1202.[159] The term "qualified small business

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[156] *See, e.g.*, Rev. Rul. 77-297. A "three-party" exchange consists of a taxpayer (A) who desires to exchange his property, a prospective purchaser (B) of the taxpayer's property, and a prospective seller (C) of the property (exchange property), that A wishes to receive in the exchange. B may not want to get involved in the exchange or in acquiring the exchange property, so a fourth party (D) may be used. D, who would earn a profit for his efforts as an unrelated intermediary, acquires the exchange property and conveys it to A in exchange for A's property. D then sells to B the property he received from A. In the case of a four-party simultaneous or deferred exchange, accomplished under the intermediary safe harbor, it is not even necessary for D to become the actual owner of any of the properties. Treas. Reg. § 1.1031(b)-2.

[157] § 1202(a)(1).

[158] § 1202(a)(4).

[159] § 1202(d).

stock" means any stock in a C corporation which is originally issued after the date of the enactment of August 10, 1993, if (a) as of the date of issuance, such corporation is a qualified small business, (b) such stock is acquired by the taxpayer at its original issue either (x) in exchange for money or other property (not including stock), or (y) as compensation for services provided to such corporation.[160] Finally, stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets active business requirements.[161]

The qualified small business stock eligible gain exclusion is the greater of: (i) 10 times the taxpayer's adjusted basis in the qualified small business stock disposed of in that year (annual limitation), or (ii) $10 million reduced by the aggregate amount of qualified small business stock gain on stock of that issuer excluded by the taxpayer in prior years (aggregate limitation).[162] While these limits (per investor) are more restrictive than the full QOZ exclusion after a 10-year hold, investors will often be satisfied with such potentially limited gain exclusion combined with the ability to exit from such investment after only 5 years. Further, depending on the size of the investment, such eligible gain exclusions limits may not ever come into play.

The main caveat in this context is to make sure such QOZB does not intend to operate one of the many non-qualifying trades or businesses, which notably includes most services and real estate businesses. A useful strategy to use if pursuing the combined Section 1202 and QOZ investment route is to consider establishing the QOZB initially as a pass-through entity. This allows the start-up losses to pass-through to the QOZB investors. Then, once the entity turns profitable, covert to a C-corporation

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[160] § 1202(c)(1).

[161] §§ 1202(c)(2), (e). The "Active Business Requirement" is met by a corporation if at least 80% (by value) of the assets of such corporation are used by such corporation in the active conduct of one or more qualified trades or businesses. There is an exception for star-up activities, researched and experimental expenditures, and activities with respect to in-house research expenses. A "Qualified Trade or Business" means any trade or business other than (i) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, (ii) any banking, insurance, financing, leasing, investing, or similar business, (iii) any farming business (including the business of raising or harvesting trees), (iv) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under Section 613 or 613A, and (v) any business of operating a hotel, motel, restaurant, or similar business. There is also an exception for working capital assets that are held (a) as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or (b) for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business.

[162] § 1202(b).

status, which would start the 5-year Section 1202 holding period and such conversion should not impact the QOZ structure already in existence. In conclusion, properly structuring a qualified small business stock entity within a QOZB can bring a possible early escape from the general 10-year holding period required under the OZ Regulations; however, the restrictions surrounding the active business requirement and the eligible types of trades or businesses under Section 1202 may operate to limit its availability as a viable QOZ investment option.

§ 7.05 CARRIED INTEREST & CRYSTALLIZATION OPTIONS FOR QOZ INVESTMENTS

[1] Carried Interest

Carried interest (also commonly referred to as "promote") is a regularly used investment incentive, particularly in real estate joint ventures and investment funds. In the partnership context, carried interest comes into play when one of the partners (typically the general partner in a limited partnership) receives an interest in such partnership in exchange for the services the general partner provides.[163] It is clear in the QOZ context that if a taxpayer receives an interest in a QOF in exchange for services, the interest is a non-qualifying investment and thus such taxpayer's investment is not eligible for QOZ benefits.[164]

Further, as briefly discussed above in Section 7.02, when a QOF acquires a QOZ Partnership Interest (i.e., its partnership interest in a QOZB), it must acquire such interest from the QOZB *solely in exchange for cash*. As such, a QOF cannot acquire an interest in a QOZB from a third party because it must acquire its interest at its original issue from the QOZB. As an extension of this rule, presumably a QOF cannot acquire a carried interest in a QOZB because it would technically be in exchange for services and would thus violate the "*solely in exchange for cash*" requirement. While there are

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[163] Income attributable to carried interest is treated as capital gain for tax purposes to the extent a partnership's underlying property is capital gain.

[164] § 1400Z-2(e)(1)(A)(ii). In the event that a taxpayer contributes both eligible gain and services, such taxpayer holds a "mixed-funds" investment, and the allocation percentages with respect to that partner are calculated by allocating to the carried interest the highest share of residual profits the mixed-funds taxpayer would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application, and then allocating to the remaining interests based on percentage capital interests (relative capital contributions). Reg. § 1.1400Z2(b)-1(c)(6)(iv)(D). If a taxpayer intends to hold such a mixed funds investment, such taxpayer should consider holding the promote at the QOF level in a separate affiliated (but recognized) entity or issuing the promote at the QOZB level. The IRS confirmed that if a taxpayer makes a qualifying investment in a QOF partnership and another partnership that the taxpayer controls has a carried interest in that QOF partnership, the profits interest does not affect the taxpayer's qualifying investment in the QOF. It does not create a mixed-funds investment.

these above limitations on how to incorporate carried interest in the QOZ context, there are also many traditional carried interest opportunities that remain viable options.

For example, because both QOFs and QOZBs must be regarded entities for tax purposes, they are often structured as entities taxed as partnerships. Generally, there will be a managing member or general partner (e.g., the operating partner) who performs the day-to-day management functions of the QOZ entity, including identifying potential investment opportunities, developing the overall investment strategy, managing the development or operation of the property, securing forms of financing, and coordinating any sale of the entity's property. The entity or individual who performs these various functions often has a carried interest in the QOZB entity. Such carried interest generally is paid when there is a capital event, which may involve a sale of assets, refinancing, or other event that generates enough actual proceeds to cover the return of capital contributions for the limited partners and other "hurdle" rate of return that such limited partners are also entitled to in the deal.

However, in some deal structures, particularly when there is a contemplated long-term hold of interests in the business or its underlying assets, the carried interest can be earned and paid out over the course of the investment at different value-generating milestones (such as stabilization of a newly constructed multi-family asset). Essentially the partners agree to adjust the ownership percentages in the entity at various pre-defined points in the future. This concept is referred to as "crystallization" and it involves a "book-up" of the capital accounts of the partners to reflect the sharing of the value created by the operating partner's efforts.

[2] Crystallization and Value Generation

The crystallization of carried interest is typically addressed in the distribution waterfall in the partnership or limited liability company agreement. It is becoming more common to pay out carried interest without the occurrence of any actual capital event, such as those identified above. Examples of crystallization events include construction completion milestones, achieving certain percentages of leased units, or stabilization in the development project setting. Crystallization of the carried interest compensates the operating partner for increases in value resulting from the operating partner's effort at the time such effort is expended through the date of the crystallization event, even though the ultimate performance of the investment might not yield any (or the same amount of) carried interest due to a subsequent drop in value, poor cash flow or additional capital contributions required after crystallization.[165] Mechanisms for crystallization can be either elective by the operator partner or QOF or automatic following the particular milestone achievement.

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[165] *See* Mitchell Berg & Peter Fisch, *Crystallization of Carried Interest in Joint Ventures*, New York Law Journal: Real Estate Trends (August 14, 2019).

When a crystallized carried interest results from a non-capital event, the partners in the investment must agree on the method used for determining value. This may be based on the amount that would be distributed to the operating partner as carried interest under the agreed upon distribution waterfall if the underlying asset were sold to a third-party as of the specified crystallization date for an all cash price equal to the appraised value of such asset, but after deducting from the proceeds of the sale a set percentage for hypothetical seller closing costs, applicable amounts to lenders or other creditors, and any other obligations the entity may have to its partners or members.[166] The appraisal process is also often identified and outlined in the partnership or limited liability company agreement of the QOZB.

[3] Payout Options

Payout options in the non-capital event crystallization scenario may include (i) each of the capital partners paying the operating partner such partner's pro rata share of the amount of the crystallized carried interest out of its own funds (this would be treated as a purchase of a non-qualifying interest by a QOF who is the capital partner), or (ii) having the crystallized carried interest be reflected through a capital account book-up as a capital contribution by the operating partner to the joint venture (which would dilute the equity interest of the capital partners on a pro rata basis) and then possibly either (a) paying the amount of the carried interest, possibly with interest, out of distributions that would otherwise be made to the capital partners (which effectively treats the carried interest as preferred equity in the joint venture) or (b) paying out the crystallized interest our of borrowings (more common).[167] After the crystallization takes place, in effect the operating partner is now *pari passu* with the QOF and capital partners to the extent the operating partner is deemed to have contributed capital to the venture, and the operating partner has given up future upside, other than on account of its newly computed capital interest, in exchange for crystallizing the carried interest early and then remaining in the venture.[168]

[4] Crystallization Pitfalls

[a] Start-Up Stage

The general mechanics of carried interest and crystallization operate the same whether they are in a traditional joint venture or QOZ investment. There are pitfalls to watch out for in the QOZ context are at the initial start-up stage and at the point of crystallization of the carried interest.

[166] Note 168, *supra*.

[167] Note 168, *supra*.

[168] Note 168, *supra*.

At the start-up stage of the QOZ investment, the parties must ensure that the QOF is not the recipient of carried interest in the QOZB. It should be clear that any carried interest recipient will not be eligible for any QOZ tax benefits.

[b] At Crystallization

At the point of crystallization, if the operating partner desires a full redemption of its interest, the parties involved should make sure that after such full redemption of the interest there are at least two tax partners remaining in the entity, otherwise the QOF or QOZB would lose its classification as a partnership for tax purposes and forfeit all QOZ benefits relating to (i) the ability to use the 70% tangible property test applicable to a QOZB (compared with the 90% Asset Test applicable to a QOF) and (ii) the ability of the QOZB to use the WCSH for reasonable working capital reserves. A QOF capital partner would want the borrowing to occur more than two years after the most recent contribution to avoid presumed disguised sale rules under Code Section 707.

§ 7.06 PROPOSED LEGISLATION IN THE QUALIFIED OPPORTUNITY ZONE CONTEXT

[1] Possible Changes

The legislation creating QOZs and QOFs is subject to additional guidance, rules and regulations, and such guidance, rules, and regulations may impact QOZ investments in the future. And in general, the U.S. federal income tax rules are constantly under review by persons involved in the legislative process and by the IRS and the Treasury Department, resulting from time to time in the adoption of new Treasury Regulations or changes to the existing regulations, revised interpretations of established concepts, as well as statutory changes. Any changes in the U.S. federal tax laws or interpretations thereof could either positively or negatively affect the tax treatment of an investment in a QOF.

Apart from the possible technical corrections or regulatory fixes that are required, practitioners in the QOZ space believe that if new legislation related to the QOZ program is passed, it will almost certainly involve one or more of the following concepts: (i) extenders, (ii) increased informational reporting requirements, and (iii) review of actual community impact. For example, as to potential extensions in the QOZ context, some practitioners argue that the December 31, 2026 gain deferral recognition date should be extended by at least two years as a result of contractions of the economy and supply chain issues brought on by the COVID-19 Pandemic. Such a change not only would increase the length of the gain deferral benefit, but it could also reinstate the 10% step-up in basis which has expired for new QOZ investments beginning January 1, 2022. Other forms of extensions could involve making the QOZ program permanent, whereby QOZ investors would not be forced to dispose of their QOZ investments by December 31, 2047 in order to receive the fair market value basis step-up.

[2] 2020 Biden QOZ Proposals

During the 2020 Presidential campaign, then-Democratic candidate for President Joe Biden proposed potentially significant changes to the current QOZ incentive implementation. Specifically, he proposed to reform Qualified Opportunity Zones by:[169]

(1) Incentivizing QOFs to partner with non-profit or community-oriented organizations to jointly produce a community-benefit plan for each investment made by the QOF. Each community-benefit plan would focus on creating jobs for low-income residents and otherwise providing a positive direct financial impact to households situated within a QOZ.

(2) Directing that the QOZ tax incentives be reviewed by the United States Department of the Treasury to ensure that these tax benefits are only being allowed where there are clear (but as yet undefined) economic, social, and environmental benefits to a community, and not just high returns to investors.

(3) Introducing transparency by requiring "recipients" (presumably QOFs) of the QOZ tax incentives to provide detailed reporting and public disclosure (the format to be determined) on their QOZ investments and the impact on local residents, including poverty status, housing affordability, and job creation.

The framework for the type of proposal in item (2) above on existing or future QOF deployments into projects is unclear and undefined without proposed legislation. A change of this nature would likely require new legislation by Congress. Further, the enhanced reporting proposal in item (3) above has been posited in one form or another on a consistent bi-partisan basis since enactment of the QOZ program. Because of the high probability of increased reporting requirements being enacted through legislation, QOFs and QOZBs should consider taking action now to start tracking details such as local hiring statistics, activity performed in QOZs, and other aspects that can support a showing of positive community impact that resulted directly or indirectly from such QOZ investment. Such details should be tracked during the construction/start-up period as well as during the actual operational period of the QOZB. In fact, sponsors of QOZ investments should start sending any data they have on these points to their congresspersons, trade associations, or other appropriate organizations to show such QOZ investment's social impact, community impact, and total amount of money that has been invested in the specific QOZ(s) in which it operates.

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[169] The Biden Plan to Build Back Better by Advancing Racial Equity Across the American Economy—Joe Biden for President: Official Campaign Website.

[3] QOZ Bills Since 2019

In this regard, several bills have previously been introduced in Congress that would revise certain aspects of the tax laws affecting QOZs. On November 6, 2019, a bill was introduced by Senator Ron Wyden (D-OR), a member of the Senate Finance Committee. Among other things, as currently drafted, that bill would have (a) required information reporting from both QOFs and their investors, (b) eliminated certain QOZs that qualified solely by virtue of being adjacent to a low income community, (c) required that a QOZB maintain 90% (not 70%) of its property in qualifying assets, and (d) excluded residential rental projects from the QOZ program unless 50% or more of the residential units were rent restricted and occupied by persons whose income was 50% or less of the area median income level. The bill provided that the exclusion of residential rental projects that would not satisfy the rent restrictions would be retroactive to the beginning of the QOZ program in 2017.[170]

On November 8, 2019, Representatives Ron Kind (D-WI), Mike Kelly (R-PA), and Terri Sewell (D-AL) introduced the bipartisan Opportunity Zone Accountability and Transparency Act, which would have required additional information reporting by QOFs. This bill proposed implementing mandatory reporting requirements, instituting penalties for not following these requirements, and making these reports available to the public. With respect to QOFs that own residential real estate, the bill would have required annual reporting of information about the size of the building, the number of residential units and the portion of the units that were occupied by persons whose income was 50% or less of the area median income level. Additionally, on December 6, 2019, Senator Tim Scott (R-SC) introduced legislation to establish reporting requirements for QOFs entitled the "Improving and Reinstating the Monitoring, Prevention, Accountability, Certification and Transparency (IMPACT) of Opportunity Zones Act." This legislation would have required QOFs to report extensive information regarding the QOF and its investments and required investors to report specific information about their QOF investment on their returns. The legislation proposed penalties for individuals and funds who failed to make timely and accurate reports. The Treasury Department would have been required (i) to release timely tracking information and (ii) to issue a comprehensive report concerning QOZs every five years that would contain demographic and economic information.

On April 17, 2020, Representative John Curtis (R-UT), on behalf of himself and Representative Henry Cuellar (D-TX), introduced the bipartisan COVID 19-Impacted Small Business Opportunity Zone Act, which would have (i) extended the recognition date for taxing Deferred Gain from the earlier of December 31, 2026 or the disposition

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[170] In early 2022, Senator Ron Wyden launched an investigation into some prominent QOFs. *See* Melanie Waddell, *Sen. Wyden Targets Scaramucci, Others in Opportunity Zone Probe*, Think Advisor (January 18, 2022).

date of the QOF investment to the earlier of the date which is seven years after the date on which the investor acquired its QOF investment or the disposition date of the QOF investment, (ii) frozen the tax rate applicable to Deferred Gain at the rate that was in effect in the taxable year in which the investor acquired its investment in a QOF, and (iii) classified certain small businesses affected by COVID-19 as QOZBs without meeting the 70% tangible property standard. A "qualified small business" is a small business that experiences any of the described business disruptions due to the spread of, or the public's or government's response to, the COVID-19 pandemic. A "small business" means any trade or business with gross receipts of less than $1,000,000, calculated under Code Section 448(c)(3), without regard to subparagraph (A). This provision would have applied for one year from the date of enactment.

More recently, on February 11, 2021, Representative Tim Burchett (R-TN), introduced the Opportunity Zone Extension Act of 2021, which would extend for two years the election and capital gain deferral periods for QOZs to December 31, 2028. Similarly, on June 25, 2021, Representative Jim Hagedorn (R-MN), introduced the Expanding Opportunity Zones Act of 2021, which would (i) increase the number of low-income communities that may be designated as QOZs, and (ii) extend by three years the election and capital gain deferral periods for QOZs to December 31, 2029. And finally, on July 21, 2021, Representative Michelle Steel (R-CA), introduced the Growth and Opportunities Act of 2021, which would permit QOZs to be designated every 10 years, with the first round occurring on January 1, 2027. Under current law, the existing zone designations expire after 10 years and no additional designations are allowed.

§ 7.07 CONCLUSION

Ultimately, investors interested in making qualifying investments in QOFs, and investors who have already made such investments, should keep an eye out for potential changes in U.S. federal income tax law, specifically as it related to the QOZ landscape. In addition to watching for substantive changes, QOZ sponsors should start tracking (or increase tracking) data related to the impact of such QOZ investments on the community as a whole (with tracking of hiring statistics from the QOZ project under their control and showing any local hiring preferences and/or requirements).