

A Compendium of Qualified Opportunity Zone Proposed Regulations: Guidance and Citations for Interpreting IRC Section 1400Z-2



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On April 17, 2019, the Treasury Department released a [second round of proposed regulations](#) (the "4/19 Regulations") providing additional guidance on the implementation of the Opportunity Zone ("OZ") tax incentive included in the Tax Cuts and Jobs Act. The 4/19 Regulations are taxpayer-friendly and expand upon (but in some cases modify) the guidance provided in the [initial proposed regulations](#) released on October 19, 2018 (the "10/18 Regulations"). This alert compiles both the 4/19 Regulations and the 10/18 Regulations and indexes the guidance in both sets of regulations with citations.

Background

The OZ regime allows taxpayers to defer gains if such gains are invested in a properly-structured qualified opportunity fund (a "QOF"). The 10/18 Regulations provide initial guidance on issues such as eligible taxpayers and gains, QOF investments, the self-certification process, and rules applicable to Qualified Opportunity Zone Business (a "QOZB") assets. The 4/19 Regulations provide expanded guidance on the OZ framework, including IRC Section 1400Z-2's interplay with the partnership tax regime, structuring QOF investments and asset acquisitions, and what it means to operate a QOZB.

Of particular note, the 4/19 Regulations:

1. Provide clarity as to how operating businesses may satisfy the 50% gross income and active trade or business requirements including with respect to some leasing activities;
2. Relax the 90% QOF testing period with respect to investments made in the latter half of a tax year;
3. Describe various gain "inclusion events" resulting in taxation of previously deferred gain;
4. Clarify that debt-financed distributions are permissible and provide that deferral is possible even in the case of certain dispositions of qualified opportunity zone property by a QOF;
5. Expand the working capital safe harbor applicable to operating businesses;
6. Provide a framework for determining "original use"; and
7. Address various technical issues (e.g., the meaning of "substantially all" in its various contexts).

This alert supplements our review of the 10/18 Regulations (available [here](#)) and provides a cumulative reference guide to the more significant information contained in both sets of proposed regulations. Although both the 10/18 Regulations and 4/19 Regulations are in proposed form, taxpayers may generally rely on the new guidance for a variety of important and previously unclear issues.

Compendium

The following summary addresses particular issues related to qualified opportunity zone investments, the way in which the proposed regulations address the issue, and the citation to the proposed regulations. Citations to the 10/18 Regulations appear in **red**; citations to the 4/19 Regulations are *italicized* and appear in **blue**.

GENERAL RULES FOR DEFERRING TAX ON GAINS BY INVESTING IN OPPORTUNITY ZONES		
<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Gains Eligible for Deferral	Capital gain only; Net 1231 gain also eligible.	Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(i); <i>Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(iii)</i>
Types of Taxpayers Eligible to Elect Gain Deferral	Individuals, C corporations (including REITs), partnerships, and most other pass-through entities.	Prop. Reg. § 1.1400Z-2(a)-1(b)(1)
Qualified Investments in a QOF	Investment must be an equity interest in the QOF, including preferred stock or a partnership interest with special allocations; debt does not constitute an investment in a QOF.	Prop. Reg. § 1.1400Z-2(a)-1(b)(3)
180-Day Rule for Deferring Gain by Investing in a QOF	The investment in a QOF must be made within 180-days of the sale or exchange giving rise to the gain; with respect to net 1231 gain, the 180-day period begins on last day of the taxable year.	Prop. Reg. § 1.1400Z-2(a)-1(b)(4); <i>Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(iii)</i>
Attributes of Included Income When Gain Deferral Ends	All of the deferred gain's tax attributes are preserved through the deferral period and are taken into account when the gain is included.	Prop. Reg. § 1.1400Z-2(a)-1(b)(5)
Contributions of Services	Services rendered to a QOF in exchange for an interest in the QOF are not eligible investments.	<i>Prop. Reg. § 1.1400Z-2(a)-1(b)(9)(ii)</i>
Transfers of QOF Interests	Acquisition of a QOF interest from a pre-existing holder of QOF equity is still a valid QOF investment.	<i>Prop. Reg. § 1.1400Z-2(a)-1(b)(9)(iii)</i>
Distributions of Refinancing Proceeds	Generally permitted to the extent of a taxpayer's basis in the QOF.	<i>Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(ii)</i>

EVENTS WHICH REQUIRE INCLUSION OF DEFERRED GAIN

<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
General Income Inclusion Rule	Deferred gain is included in income on the earlier of (1) an “inclusion event,” or (2) December 31, 2026.	Prop. Reg. § 1.1400Z-2(b)-1(b)
Definition of “Inclusion Event” for Gain Recognition	Examples of inclusion events include: <ul style="list-style-type: none"> • Dispositions of QOF interests (whether held directly or indirectly), • Certain QOF distribution/ liquidation events (rules vary depending on type of entity), and • Reorganization events involving a QOF or investor entity. 	Prop. Reg. § 1.1400Z-2(b)-1(c)
Are Transfers of QOF Interests Inclusion Events?	Not in all cases, e.g., so long as the new “upper tier” partnership follows certain rules; transfers upon death are also excluded.	Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(ii) ; Prop. Reg. § 1.1400Z-2(b)-1(c)(4)
Calculation of Holding Period	Holding period for an interest in a QOF generally begins on date of contribution.	Prop. Reg. § 1.1400Z-2(b)-1(d)(1)
Calculation of Amount Includible in Income	The amount of originally deferred gain less gain required to be recognized as a result of an “inclusion event.”	Prop. Reg. § 1.1400Z-2(b)-1(e)(1)
Basis Adjustments Following Gain Recognition	Basis adjustment mechanics vary depending on the type of entity involved.	Prop. Reg. § 1.1400Z-2(b)-1(g)

GAINS OF PARTNERSHIPS AND PARTNERS

<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Deferrals for Partnerships and Partners	A partnership may elect deferral of gain and, to the extent that the partnership does not elect deferral, a partner may do so; certain notification requirements must be satisfied.	Prop. Reg. § 1.1400Z-2(a)-1(c)(1) ; Prop. Reg. § 1.1400Z-2(b)-1(h)

Application of 180-Day Rule to Partnerships and Partners	A partner's 180-day period generally begins on the last day of the partnership's taxable year. But a partner may also choose to begin her own 180-day period on the same date as the start of the partnership's 180-day period.	Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)
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ELECTION FOR BASIS STEP-UP WHERE INVESTMENTS HELD AT LEAST 10 YEARS

<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Availability of Basis Step-up	Only available for gains that are deferred under the general OZ rules.	Prop. Reg. § 1.1400Z-2(c)-1(a)
Date by which the Election must be Made	December 31, 2047. This is 20½ years after June 2027 - the latest date that an eligible taxpayer may properly defer gain under the qualified opportunity zone rules (the latest gain subject to deferral would be at the end of 2026, so the last day of the 180-day period for that gain would be in late June 2027).	Prop. Reg. § 1.1400Z-2(c)-1(b)
Do Investors Qualify for Exclusion Upon Asset Dispositions by a QOF?	Yes, if the ten-year holding period in the QOF is met and the investor makes the necessary election.	Prop. Reg. § 1.1400Z-2(c)-1(b)(ii)(A)

RULES FOR OPERATING QUALIFIED OPPORTUNITY ZONE BUSINESSES

<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Working Capital Safe Harbor for QOF Investments	QOZB may hold cash, cash equivalents, or short-term debt for up to 31 months, provided the business: (1) designates such amounts in writing for the development of a trade or business (the 4/19 Regulations modify the 10/18 Regulations as to this prong), (2) has a written expenditure schedule consistent with the ordinary business operations showing that the property will be used within 31-months, and (3) substantially complies with that schedule.	Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)

Extended Working Capital Timeline	QOFs may benefit from multiple overlapping or sequential applications of the working capital safe harbors, provided each safe harbor meets the three requirements above.	<i>Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(D)</i>
What Does “Original Use” Mean?	Generally, “original use” commences on the date property is placed in service in the QOZ.	<i>Prop. Reg. § 1.1400Z-2(d)-1(c)(7)</i>
What does “Substantially All” Mean for QOF purposes?	For use of property, at least 70% of the property must be used in a qualified opportunity zone; with respect to holding period, it means 90% of the QOF or QOZB’s holding period; and with respect to QOZB’s held by a QOF, such entity must be a QOZB for 90% of the QOF’s holding period.	<i>Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(iv); Prop. Reg. § 1.1400Z-2(d)-1(c)(5); Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(iii); Prop. Reg. § 1.1400Z-2(d)-1(c)(5);</i>
Special Rules Apply to Leased Property for Purposes of the Qualified Opportunity Zone Business Property Requirements	If a QOF leases tangible property and puts it to use in the zone, such property is QOZB property, provided it is substantially improved or the QOF makes original use of the leased property.	<i>Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(i)</i>
QOF Rules for Unimproved Land in a Zone	A QOF cannot make original use of land in a zone. Unimproved land does not need to be substantially improved. A QOF or QOZB must use land in a trade or business.	<i>Prop. Reg. § 1.1400Z-2(d)-1(d)(4)(ii)(B)</i>
What is a “Trade or Business”	The term “trade or business” means a trade or business within the meaning of Section 162.	<i>Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(ii); Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(ii)</i>
Does Entering into a Triple-Net-Lease Constitute an Active Trade or Business?	Somewhat unclear; the regulations state that “merely entering into a triple-net-lease” does not result in an active trade or business.	<i>Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(B)</i>

How Does a QOZB Satisfy the 50% Gross Income Requirement?	There are three safe harbors based on: (1) services performed in the zone based on hours; (2) services performed in the zone based on amount paid for services; and (3) income generated by tangible property and operational functions performed in the zone. If no safe harbor is met, a facts and circumstances test applies.	<i>Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)</i>
Special Rule for Property Adjacent to an OZ	So long as the amount of real property located within the OZ is substantial (based on square footage), contiguous property owned outside the OZ is deemed to be located within the OZ for purposes of the 50% gross income test noted above.	<i>Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(ii)</i>
RULES FOR A QUALIFIED OPPORTUNITY FUND		
<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Certification of an Entity as a QOF	Taxpayers can use Form 8996 both for initial self-certification and for annual reporting of compliance with the 90 percent asset test.	<i>Prop. Reg. § 1.1400Z-2(d)-1(a)(1)</i>
Designating When a QOF Begins	A QOF can: (1) identify the taxable year in which the entity becomes a QOF, and (2) choose the first month in that year to be treated as a QOF.	<i>Prop. Reg. § 1.1400Z-2(d)-1(a)(2)</i>
Pre-Existing Entities	Pre-existing entities can qualify as QOFs.	<i>Prop. Reg. § 1.1400Z-2(d)-1(a)(3)</i>
Valuation Method for Applying the 90 Percent Asset Test	The 10/18 Regulations were modified to allow both QOFs and QOZBs to choose between the “Financial Statement” and “Alternative Valuation” method, regardless of whether the QOF has applicable financial statements.	<i>Prop. Reg. § 1.1400Z-2(d)-1(b)</i>

Testing Timeline for 90 Percent Asset Test	Generally, tested every six months (twice a year), but capital contributions received in a prior six-month period are excludable under the 4/19 Regulations.	<i>Prop. Reg. § 1.1400Z-2(d)-1(a)(2)(i); Prop. Reg. § 1.1400Z-2(d)-1(b)(4)</i>
Reinvestment by a QOF of Certain Proceeds	If properly reinvested within a 12-month period, such proceeds are considered qualified opportunity zone property for purposes of the 90% test.	<i>Prop. Reg. § 1.1400Z-2(f)(1)(b)</i>
Penalty for Failure to Maintain 90 Percent of Qualified Opportunity Zone Property	The penalty does not apply before the first month in which the entity qualifies as a QOF.	<i>Prop. Reg. § 1.1400Z-2(d)-1(a)(2)(ii)</i>
Asset Test for QOF Investing directly in Qualified Opportunity Business Property (i.e. direct ownership of tangible property in the zone)	If a QOF operates a trade or business directly using tangible property in the zone, at least 90 percent of the QOF's assets must be qualified opportunity zone business property.	<i>Prop. Reg. § 1.1400Z-2(d)-1(c)</i>
Asset Test for QOF Investing in Qualified Opportunity Zone Business (i.e. indirect ownership of tangible property in the zone through a corporation or partnership conducting business in the zone).	If a QOF operates a trade or business through one or more entities, then the QOF can satisfy the 90 percent asset test if each of the entities qualifies as a qualified opportunity zone business and substantially all the assets of those entities are qualified opportunity zone business property.	<i>Prop. Reg. § 1.1400Z-2(d)-1(d)(1)</i>

Taxpayers with questions about QOFs or the proposed regulations can contact Christopher Karachale at ckarachale@hansonbridgett.com, Daren Shaver at dshaver@hansonbridgett.com, or the Hanson Bridgett Tax Practice Group.