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An In-Depth Guide To Latest Opportunity Zone Regs: Part 2

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This is the second part of an article that analyzes the second tranche of proposed regulations for the opportunity zone provisions set forth in Internal Revenue Code Section 1400Z-2. **Part 1 of this article** focused on investor issues such as inclusion events regarding the eligible gain being deferred, whether an investment in a qualified opportunity fund is a qualifying investment, the 10-year benefit and other items.

This article will focus on the compliance requirements for qualified opportunity funds, clarification of the requirements for an asset to be considered to be qualified opportunity zone business property, the new rules for leases of real and tangible personal property, the new rules with respect to qualified opportunity zone businesses (which includes operating businesses), and the special rules with respect to real estate.

In the event that a term is not defined here, the term may be defined in Part 1 of this article and such definition should be used here.

Qualified Opportunity Fund Compliance Requirements

Valuation of Assets for Purposes of the 90% Test

A qualified opportunity fund, or QOF, is required to hold at least 90% of its assets in qualified opportunity zone property, or OZP, as defined in Section 1400Z-2(d)(2), which is determined by taking the average of the percentage of OZP held by the QOF, as measured on the last day of the first six-month period of the taxable year of the QOF, and on the last day of the taxable year of the QOF. The first tranche provided that the “first six-month period of the taxable year of the QOF” means the first six months each of which is in the taxable year and in each of which the entity is a QOF. This means that, where an entity is organized to be a QOF and receives its first contribution in August in exchange for an equity interest intending to be a qualifying investment, the first testing date with respect to the 90% test will be on Dec. 31.

The first tranche provided that, for a taxable year, if the QOF has an applicable financial statement, or AFS, then the value of each asset of the QOF for purposes of the 90% test is the value of the asset as reported on the QOF’s AFS for the relevant reporting period — the financial statement method. The first tranche also provided that, if a QOF does not have an AFS, then the value of each asset of the QOF is the cost of the asset — the cost method.

The second tranche modified this by providing the QOF with flexibility to choose which method to use. Specifically, the QOF may use the financial statement method if the QOF has an AFS, or the QOF may use the alternative valuation method, which appears to be very similar to the cost method. Whichever method the QOF chooses for a taxable year, the QOF must apply the method consistently to all assets valued for such taxable year. It should be noted that a QOF may select the financial statement method to value tangible property leased by the QOF only if the AFS of the QOF is prepared according to U.S. generally accepted accounting principles and requires an assignment of value to the lease of the property.

Under the alternative valuation method, the value of each asset that is owned by the QOF is the QOF's unadjusted cost basis of the asset under Section 1012. This is essentially the purchase price paid by the QOF for the asset. With respect to an asset that is leased by the QOF, the value of such leased asset under the alternative valuation method is equal to the present value of the leased asset as calculated at the time that the QOF enters into the lease as further determined in the second tranche.

It is not clear why a QOF with an applicable financial statement would choose to use the financial statement method over the alternative valuation method. Arguably, the QOF would need to project out the 90% test over the expected holding period for all of its assets with respect to the financial statement method before making this decision because the asset values will change each year under this method. Some have argued that the financial statement method could result in lower penalties for failure to satisfy the 90% test as a result of the decline in the value of the assets over time under this method.

Recent Cash Contributions and the 90% Test

Under the 90% test which is tested twice a year, cash is generally not treated as OZP. This means that the QOFs have a limited period of time to convert any contributed cash into OZP under the 90% test or face a penalty. The second tranche provides some relief for QOFs. In determining compliance with the 90% test, for each testing date, it is an option for the QOF to exclude from the numerator and the denominator of the 90% test any property that was received by the QOF partnership as a contribution, where the contribution occurred not more than 6 months before the testing date for the 90% test, and where between the contribution date and such testing date, the amount was continuously held in cash, cash equivalents or debt instruments with a term of 18 months or less. The QOF does not need to be consistent from one semiannual testing date to another as to whether it chooses to use this exclusion option.

Assume that a timely cash contribution is made to a calendar year QOF partnership in June and a qualifying investment is obtained by the taxpayer, to the extent that a taxpayer election applies. Also, assume that June is the first month that the QOF partnership will self-certify as a QOF. The QOF can elect to not factor the June cash contribution and subsequent cash contributions into the numerator and denominator for the 90% test on the first testing date (which is on the last date in November) as long as the amounts are still being held in cash on such testing date. To the extent that any portion of the June cash contribution is still being held in cash on the second testing date that occurs on Dec. 31, such amounts will be factored into the 90% test. This means that the QOF will need to convert some portion of the contributed cash from June into OZP by Dec. 31.

However, if the cash contributions to the QOF were made in July and July is the first month that the QOF partnership will self-certify as a QOF, then the QOF can elect to not factor the July cash contribution and subsequent cash contributions into the numerator and denominator for the 90% test on the first testing date (which is on Dec. 31) as long as the amounts are still being held in cash on such testing date but the QOF will need to convert some portion of the cash contributed in July into OZP by the second testing date (which is the last date in June of the following year). Effectively, the QOF has at least six months to convert the contributed cash into OZP and almost one year in certain cases.

Please note that removing the recently contributed cash from the numerator and denominator for the 90% test may not have been the best approach technically. If, on a testing date, all of the assets of the QOF consists of cash contributed within the last six months and the QOF were to remove all of the cash from both the numerator and denominator for the 90% test, then it appears that the 90% test would result in an undefined amount on such testing date (which perhaps means 0%). This was obviously not the intent of this provision in the second tranche. Perhaps, the option should be instead to treat the cash as OZP for purposes of the 90% test.

Clarification Regarding Opportunity Zone Property

OZP includes certain shares of stock or partnership interests in a domestic corporation or partnership, respectively, that are issued to the QOF after Dec. 31, 2017, in an original issuance (or through an underwriter, with respect to a corporation), in exchange for cash, as long as the entity is a qualified opportunity zone business, or OZB, as defined in Section 1400Z-2(d)(3), on certain testing dates, and during "substantially all" of the QOF's holding period for such shares of stock or partnership interests.

The second tranche provides that the term "substantially all" means at least 90%. The second tranche did not provide guidance on how to satisfy this test. Perhaps, it is based upon the entity meeting the requirements of being an OZB for at least 90% of the months during a taxable year. This is an area where clarification is much needed.

Qualified Opportunity Fund Reinvestment Rule (Interim Gains)

The Interim Gains Issue

Where a QOF partnership sells an asset that both qualifies as OZP and results in a capital gain, the taxpayers of the QOF partnership are subject to income tax to the extent that they have not obtained the 10-year holding period and will be allocated such gain even where the QOF reinvests the proceeds in OZP. Many comment letters requested that income or gains generated by the sale of assets by the QOF or the OZB not be subject to income tax for the taxpayers to the extent that the QOF reinvests the sales proceeds in OZP within a certain amount of time — the issue that subjects the taxpayers to income tax is hereinafter referred to as the interim gains issue.

No Regulatory Authority for Nonrecognition of Income

The opportunity zone provisions provide that the U.S. Department of the Treasury shall prescribe regulations as may be necessary to carry out the purposes of the opportunity zone provisions, including rules to ensure that a QOF has a reasonable period of time to reinvest the return of capital from the equity in an OZB, and to reinvest proceeds received from the sale or disposition of OZP. However, in the preamble to the second tranche, the Department of the Treasury and the IRS determined that they do not have the regulatory authority to prescribe rules resolving the interim gains issue.

Reinvestment Exception to the 90% Test

The second tranche still provided some relief to QOFs and investors with respect to the interim gains issue. Under the 90% test, cash is considered to be a "bad asset" since it is not considered to be OZP. Failure to satisfy the 90% test results in a penalty that could be significant. The second tranche provides relief from this penalty while the cash is being held by the QOF for timely reinvestment in OZP.

If a QOF receives proceeds from the return of capital or the sale of disposition of some or all of its OZP and the QOF reinvests some or all of the proceeds in OZP by the last day of the 12-month period beginning on the date of the distribution, sale or disposition, then the proceeds, to the extent that they are so reinvested, are treated as OZP for purposes of the 90% test. If the reinvestment of proceeds is delayed as a result of waiting for government action where the application requesting government action has been completed (such as an application for a building permit), then such delay does not cause a failure with respect to the 12-month requirement to reinvest. However, it is required that the QOF continuously hold the proceeds in cash, cash equivalents or debt instruments with a term of 18 months or less.

It is possible for a QOF partnership to alleviate a portion of the impact of the interim gains issue by making a distribution to the taxpayers in a sufficient amount so that the taxpayers can pay income tax on the gain generated from the QOF partnership's sale of the OZP.

For example, in 2019, two taxpayers each obtained a qualifying investment by making a timely capital contribution related to an eligible gain in the amount of $1 million each to a QOF partnership (each representing 50% of the capital contributed to the QOF) and making a taxpayer election. The basis that each taxpayer has in his or her qualifying investment will be zero. Also, in 2019, the QOF partnership acquired four OZP assets for $500,000 each. In 2022, the QOF will sell one of the OZP assets to a third party for $1 million — generating a taxable capital gain of $500,000 from such sale. Each taxpayer will be allocated a taxable capital gain of $250,000 in 2022 from such sale, which subjects each taxpayer to approximately $50,000 of federal income tax (assuming a 20% long term capital gains tax rate). The QOF partnership reinvests $900,000 of $1 million of sales proceeds in OZP within 12 months of the original sale by the QOF partnership. In January 2023, the QOF distributes to each taxpayer an amount of $50,000 as a distribution to pay taxes.

For purposes of the 90% Test, the $900,000 of cash that is reinvested should be treated as OZP because it was reinvested in OZP within 12 months of the original sale by the QOF partnership, but the remaining $100,000 (eventually distributed as a tax distribution) is not treated as OZP on any of the testing dates. Still, the $100,000 of cash should not cause any problems for the QOF as long as it represents 10% or less of the value of the assets held by the QOF (assuming all of the other assets held by the QOF partnership are considered to be OZP) for purposes of the 90% test.

The distribution of $50,000 to each of the taxpayers in January 2023 should not generally result in an inclusion event because each of the taxpayers should be able to increase their tax basis in their qualifying investment in 2022 by $250,000 as a result of being allocated their portion of the taxable gain, and therefore the $50,000 distribution to each taxpayer in January 2023 should not exceed the taxpayer’s tax basis in the qualifying investment.

Opportunity Zone Business Property

OZBP is tangible property used in a trade or business of the OZB or the QOF (as the case may be) that was acquired by the OZB or the QOF (as the case may be) by purchase from an unrelated person after Dec. 31, 2017, and satisfies other certain requirements.

OZBP — The Holding Period and Use Requirements

An additional requirement for tangible property to be OZBP is that during “substantially all” of the QOF’s or OZB’s holding period for such property, “substantially all” of the use of such property must be in an opportunity zone. The second tranche provided answers to the “substantially all” requirements here by stating that during 90% of the QOF’s or OZB’s holding period for such property, 70% of the use of such property must be in an opportunity zone.

It is unclear how to determine whether tangible property is being used in an opportunity zone. This is particularly difficult where the tangible property is being moved within and without an opportunity zone. Perhaps, the appropriate measurement should be based upon hourly increments measuring whether the tangible property is actually being used in an opportunity zone. A particular concern is storage. The issue is whether the time that tangible property is being stored in an opportunity zone qualifies as use in an opportunity zone — especially where the tangible property is being transported during the day for use outside of an opportunity zone.

Another area of needed clarity is to determine how a holding period of 90% interplays with the 70% use requirement. Some have suggested that this simply means that the tangible property needs to be used within an opportunity zone 63% of the time (i.e., 70% of 90%). Clarity in this area would be very helpful so that the QOF and the OZB can properly track its tangible assets to satisfy these requirements.

OZBP — Original Use & Substantial Improvement Requirements

An additional requirement for tangible property to be considered to be OZBP is that either: (1) the original use of the tangible property in the opportunity zone is required to commence with the OZB or the QOF (as the case may be), or (2) the OZB or the QOF (as the case may be) is required to substantially improve the tangible property. There are special rules for land with respect to these requirements that are discussed later in this article.

New Tangible Property

The second tranche provides that the original use of tangible property in an opportunity zone commences on the date any person first places the property in service in an opportunity zone for depreciation or amortization purposes. This means that, with respect to tangible property that has been acquired by purchase by the QOF or the OZB, the QOF or the OZB must have been the first person to place the tangible property in service in an opportunity zone to satisfy the original use requirement. This should not be a problem for new tangible property acquired by purchase by the QOF or the OZB.

The merchant building community appears to be satisfied with these provisions because their business model is to construct a building with the intent to immediately sell the building to a third party. A building is generally considered to be placed in service when a certificate of occupancy is obtained for the building. Accordingly, it would appear to be possible for a merchant builder to construct a building in an opportunity zone and sell the land and the building to a QOF or an OZB prior to the building being placed in service. It is unclear whether the same is true for construction that commenced on a building prior to Jan. 1, 2018.

Used Tangible Property

Used tangible property acquired by purchase by the QOF or the OZB can satisfy the original use requirement as long as the property was not previously used or placed in service in the opportunity zone. This means that tangible property used by another in the opportunity zone that is sold to the QOF or the OZB cannot satisfy the original use requirement. Instead, such tangible property needs to be substantially improved by the QOF or the OZB to become OZBP. Again, there are special rules for land that are discussed later in this article.

For example, if an OZB were to acquire equipment from an unrelated seller who is already using the equipment in the opportunity zone, then the OZB will need to substantially improve the equipment in order for it to satisfy all of the requirements to be treated as OZBP. The preamble to the second tranche states that the determination with respect to the substantial improvement requirement is made on an asset-by-asset basis. Presumably, this means that the particular used equipment being acquired would need to be refurbished or renovated to satisfy the substantial improvement requirement.

The preamble to the second tranche provides that the Treasury and the IRS have contemplated applying an aggregate approach to the substantial improvement requirement. It is unclear how this would work to satisfy the substantial improvement requirement. Perhaps, the substantial improvement requirement would be satisfied with respect to used tangible property acquired by a QOF or an OZB that does not satisfy the original use requirement where the QOF or the OZB acquires additional original use tangible property that is similarly grouped over a subsequent 30-month period where the aggregate tax bases of such assets exceed the aggregate tax basis of the used nonoriginal use tangible property. Using the aggregate approach might be helpful with respect to operating businesses in certain circumstances such as an acquisition of an existing business in an opportunity zone. There appears to be concern in this area with respect to potential abuses. Accordingly, any use of an aggregate approach must include appropriate safeguards to prevent these potential abuses.

Vacant or Unused Tangible Property

If tangible property was unused or vacant for an uninterrupted period of at least five years before being acquired by the QOF or the OZB, then the QOF or the OZB can be considered to be the original user of such property in the opportunity zone by using or placing the property in service in the opportunity zone. This means that a building that has been continuously vacant for at least the last five years before being acquired by the QOF or the OZB does not need to satisfy the substantial improvement requirement because it can meet the original use requirement by having the QOF or the OZB place the building in service.

Many of the comment letters asked for the period described above with respect to vacant property to be one year. Perhaps, the Treasury and the IRS were concerned that a building that has only been vacant for one year might not need to be improved by the QOF or the OZB to be operational. Therefore, the substantial improvement requirement requires the QOF and the OZB to make improvements to the building. It is apparent in the preamble to the second tranche that not making any capital improvements to acquired property is not viewed favorably by the Treasury and the IRS. It is likely that a building that has been vacant for at least five years will need more than a nominal amount of capital expenditures to become operational.

Inventory in Transit

In determining whether tangible property is OZBP, at least 70% of the use of such property must be in an opportunity zone. The second tranche provided that inventory (including raw materials) of a trade or business will not fail to be used in an opportunity zone solely because the inventory is in transit either from a vendor to a facility of the trade or business that is in an opportunity zone or from a facility of a trade or business in an opportunity zone to customers of a trade or business not located in an opportunity zone.

This provision is helpful for a business operating within an opportunity zone and attempting to qualify as an OZB. It would also be helpful if this provision applied to the temporary storage of raw materials outside of an opportunity zone for processing within an opportunity zone and owned by such business.

Leased Property

Whether leased tangible property can be considered to be OZBP has been a pressing question with respect to the opportunity zone incentive. The second tranche answered this question in a favorable manner.

Leased Property Can Be OZBP

The second tranche provided that tangible property that is leased by the QOF or the OZB can be OZBP where certain requirements are satisfied. First, the property must be acquired by the QOF or the OZB under a lease entered into after Dec. 31, 2017. Second, at the time that the lease is entered into, the terms of the lease must be market rate (i.e., the terms reflect common, arms-length market practice in the locale that includes the opportunity zone under Section 482). These provisions are good news for Native American tribes where development on tribal land is undertaken using long-term ground leases.

However, where a ground lease is provided at a discount (that is not market rate), it is likely that the leased tangible property will not be treated as OZBP. This may not be detrimental for an OZB. With respect to an entity attempting to qualify as an OZB, one of the requirements is that the entity be engaged in a trade or business in which at least 70% of the tangible property, owned or leased, by such entity is OZBP. Accordingly, an entity could lease or own tangible property that does not qualify as OZBP as long as its aggregate value does not represent more than 30% of the total value of all of the tangible assets that the entity owns and leases. Under the alternative valuation method, leases of tangible property are valued at an amount that is equal to the present value of the lease payments over the term of the lease as calculated when the QOF or the OZB enters into the lease using a discount rate based upon the applicable federal rate. For purposes of this determination, the term of the lease includes periods where the lessee may extend the lease at a predefined rent.

Related Party Leases

Better news is that it is possible for a lease of tangible property between a lessor and a related QOF or OZB to be OZBP by satisfying some additional requirements. First, the lessee cannot make a prepayment in connection with the lease related to a period of use of the tangible property that exceeds 12 months. Second, with respect to leased tangible personal property, during the earlier of the last date of the lease term or the 30-month period that begins on the date that the lessee takes possession of the tangible personal property under the lease, the lessee must become the owner of tangible property that is OZBP having a value equal to or greater than the value of the leased tangible personal property. Additionally, with respect to leased tangible personal property with related parties, there is a requirement that both the leased tangible personal property and the acquired OZBP must be used substantially in the same opportunity zones.

Caution should be exercised here with a lease of tangible property between related parties. If it is determined that the lease is really an installment sale rather than a true lease for federal income tax purposes, then the QOF or the OZB will be considered to have acquired tangible property that is non-OZBP (because it is treated as a sale between related parties). This could happen where an asset is leased for a term that is near or beyond its useful life. Having the tangible property be non-OZBP could cause a problem under the 70% test and cause the entity to fail to be treated as an OZB. If the entity fails to satisfy the requirements to be an OZB, then the QOF may not satisfy the requirements for the 90% test, resulting in penalties. An opinion from a tax professional that the transaction is a lease for federal income tax purposes might be good practice here.

No Substantial Improvement Required

Interestingly, leased tangible property is not required to be substantially improved. This means that an OZB can lease a building located in an opportunity zone and not be required to substantially improve the building in order for the leasehold interest in the tangible property to be considered to be OZBP.

Again, caution should be taken here. If the lease of the building was not considered to be a lease for federal income tax purposes (because of the term of lease being too long), then the OZB is considered to have acquired the building by purchase for federal income tax purposes. In such as case, the OZB would need to substantially improve the building in order for the building to be considered to be OZBP. Again, since the stakes are high, this is an area where a tax opinion may be necessary as to whether the lease is a true lease for federal income tax purposes.

Anti-Abuse

The rules for leases of tangible property were focused on preventing perceived abuses. The Second Tranche also provided a general anti-abuse provision. Accordingly, a lease of a building cannot be OZBP where at the time the lease was entered into, there was a plan, intent, or expectation that the building was to be purchased for an amount other than fair market value determined at the time of the purchase (without regard to any prior lease payments).

Improvements to Leased Property

Any improvements made by a lessee to leased tangible property satisfy the original use requirement as purchased property. This means that if the lease of tangible property to an OZB fails any of the requirements and it is not considered to be OZBP, then the improvements made to the leased tangible property can be OZBP and be used to satisfy the 70% test. This is an important clarification especially since the improvements will revert back to the fee lessor at the end of the lease term.

Special Rules for Real Estate

The Substantial Improvement Requirement

The substantial improvement requirement (which is a requirement for tangible property to be considered to be OZBP where such property does not meet the original use requirement) provides that during any 30-month period commencing after the acquisition date of the tangible property, additions to the income tax basis “with respect to” such property in the hands of the QOF or the OZB (as the case may be) must exceed an amount equal to the adjusted income tax basis of such property at the beginning of such 30-month period in the hands of the QOF or the OZB (as the case may be).

Building Acquisition Rule Exception

The first and second tranches provide special rules for real property involving land and a building. Specifically, where a building is acquired located on land that is wholly within the opportunity zone, the substantial improvement requirement is measured in relation to the QOF’s or the OZB’s additions to the adjusted basis of the building only and there is no requirement to separately substantially improve the land upon which the building is located.

For example, an OZB acquires a previously used building that has been vacant for the last six months and the underlying land for $10 million. Of the $10 million purchase price, $6 million is allocated to the land and $4 million is allocated to the building. The acquisition needs to satisfy the substantial improvement requirement, but the acquisition price of the land is not required to be included in this determination. Accordingly, the OZB needs to make improvements to the building that increase the tax basis of the building by more than $4 million.

Special Land Acquisition Rule Exception

The second tranche provides another special rule that states that unimproved land within an opportunity zone and acquired by purchase is not required to be substantially improved. However, in order for the property to be OZBP, it is required to be used in a trade or business of the QOF or the OZB. For these purposes, “trade or business” means a trade or business under Section 162. Section 162(a) permits a deduction for ordinary and necessary expenses in carrying on a trade or business. There are many cases and rulings interpreting the term “trade or business” for purposes of Section 162. The term “trade or business” has also been used in a number of recent changes to the code — most notably with respect to the deduction under Section 199A. It is important to get acquainted with the use of the term “trade or business” under Section 162.

The special land acquisition rule has led folks to speculate that this incentive can be used to finance acquisitions of land where little or no capital expenditures are needed to operate the land in a trade or business, such as a surface parking lot. However, the IRS is concerned that unimproved property could be used in a manner leading to results that are inconsistent with the purposes of Section 1400Z-2. The preamble to the second tranche provides that, under the anti-abuse rules, a transaction can be recast to treat the acquisition of the unimproved land as an acquisition of non-OZBP where a significant purpose for acquiring such unimproved property was to achieve an inappropriate tax result.

The preamble to the second tranche provided an example of a transaction involving unimproved land where the tax results were inconsistent with the purposes of Section 1400Z-2. In that case, a parcel of land was acquired by a QOF that was utilized at the time of acquisition entirely by a business for producing an agricultural crop, and the QOF did not invest any new capital in, or increase any economic activity or output of, the parcel. Still, the amount of additional capital that is needed to be expended, or the amount of the increased economic activity that needs to take place, to not run afoul of the anti-abuse rule remains a question here.

The second tranche further provides that the special land acquisition rule does not apply where the QOF or OZB acquires unimproved or minimally improved land with the expectation, intention, or view not to improve the land by more than an “insubstantial amount” within 30 months after the date of purchase. It is unclear what is an “insubstantial amount” for these purposes. One can argue that if substantial improvement means the addition to tax basis that is more than 100% of the acquisition price, then anything less than 100% is insubstantial. It appears that the special land acquisition rule and these provisions are the result of discomfort in the industry of having a substantial improvement requirement of 100% — which in certain areas of the country is difficult to satisfy because of escalating land prices. Still, folks are going to need more visibility on what an “insubstantial amount” means here — especially for real estate projects where the improvements to the unimproved land are not expected to exceed more than the acquisition cost of such land. It may a good idea to have a safe harbor when improvements of a certain percentage of the cost of unimproved land are made. Perhaps, this percentage should be 25%.

Opportunity Zone Business Requirements (Operating Businesses)

In order for an entity to qualify as an OZB, there are five requirements that the entity needs to satisfy. This article previously discussed one of these requirements — the 70% test. The second tranche did not change anything with respect to the prohibition on OZBs engaging in certain sin businesses as trades or businesses. The second tranche provided additional guidance on the other three requirements. This additional guidance is particularly useful for operating businesses.

50% Gross Income Requirement

It is required that at least 50% of the gross income of an OZB is derived from the active conduct of a trade or business in the opportunity zone.

Safe Harbors

The situs requirement with respect to the 50% gross income requirement has been controversial. Before the second tranche was released, it was uncertain as to whether a manufacturing company with all of its property and employees located in an opportunity zone could satisfy this requirement if the goods that it manufactures were shipped to customers located outside of the opportunity zone. The second tranche appears to have answered this question by providing three safe harbors for a trade or business to satisfy the 50% gross income requirement. It is also provided a facts and circumstances test which is not discussed here. The three safe harbors are as follows:

- At least 50% of the services performed for the trade or business (based upon the number of hours performed by employees, independent contractors, and employees of independent contractors) are performed in an opportunity zone during a taxable year.
- At least 50% of the services performed for the trade or business (based upon the total amount paid by the entity for services performed by employees, independent contractors, and employees of independent contractors) are performed in an opportunity zone during a taxable year. This safe harbor provides more weight on highly compensated employees.
- The tangible property of the trade or business located in the opportunity zone and the management or operational functions performed in the opportunity zone are necessary for the generation of at least 50% of the gross income of the trade or business. This appears to be the safe harbor that most OZBs will use to satisfy the 50% gross income requirement.

The second tranche provides an example of a landscaping business that satisfies the 50% gross income requirement. The business has its headquarters in the opportunity zone, and its daily operations are managed at the headquarters for business activities that are within and without the opportunity zone. All of the equipment and supplies are stored at the headquarters. The activities occurring at the headquarters and the storage of the equipment and supplies in the opportunity zone are, taken together, a material factor in the generation of income of the business.

Real Estate as an Active Trade or Business

The second tranche provides that the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, “merely entering” into a triple net lease with respect to real property that is owned is not the active conduct of a trade or business. Discussion has ensued as to whether a modified gross lease would be the active conduct of a trade or business. It appears that having activity within the opportunity zone is important here. Accordingly, one should consider making sure that the lease requires the OZB, as landlord, to be obligated to undertake activities that will occur at the property within the opportunity zone, such as maintenance obligations.

Intangible Property Requirement

It is required that a “substantial portion” of the intangible property of an OZB must be used in the active conduct of a trade or business in the opportunity zone. The second tranche provided that the term “substantial portion” means at least 40%.

It is still unclear how to meet the situs requirement here. Does this mean that where an OZB is in the software development and management business, at least 40% of its customers that are leasing software developed by the OZB needs to be located within an opportunity zone? It is difficult to imagine that this would be required. In any event, more clarity is needed in order to measure whether intangible property is being used within an opportunity zone in order for QOFs to feel comfortable investing in technology companies.

Nonqualified Financial Property Requirement

The last requirement is that no more than 5% of the average of the aggregate unadjusted tax bases of the property of the business can be attributable to nonqualified financial property, or the NQFP requirement. The NQFP requirement requires testing each taxable year using the average of the aggregate unadjusted bases of property of the entity that may be attributable to nonqualified financial property. The definition of “nonqualified financial property” means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property specified in the regulations. The term “nonqualified financial property” does not include reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less, nor does the term include accounts or notes receivable acquired in the ordinary course of business for services rendered or from the sale of inventory.

Safe Harbor for Reasonable Working Capital

As discussed below, the first tranche provided a safe harbor for reasonable working capital and the second tranche expanded this safe harbor. Specifically, reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less (collectively, the working capital assets) are excluded from being nonqualified financial property.

The second tranche modified the safe harbor created in the first tranche for working capital assets to be considered reasonable working capital. The safe harbor in the second tranche has the following three requirements:

- The amounts are designated in writing that identifies the working capital assets being held for the development of a trade or business in an opportunity zone, including when appropriate, the acquisition, construction, and/or substantial improvement of tangible property in an opportunity zone;

- There is a written schedule (collectively, the working capital designation and the written schedule are referred to as the written plan) consistent with the ordinary start-up of a trade or business for the expenditure of such assets and the schedule demonstrates that the working capital assets will be spent within 31 months of receipt by the business; and

- The working capital assets are actually used in a manner that is substantially consistent with the written plan.

Essentially, an entity can hold the cash contributed by the QOF for up to 31 months and not run afoul of the NQFP requirement as long as cash is used in manner that is substantially consistent with the written plan. The second tranche provides that, where the consumption of the working capital assets is delayed past such 31 months as a result of the waiting for government action where the application requesting government action has been completed, such as an application for a zoning change, the delay does not cause the entity to fail to use such assets substantially consistent with the written plan.

Under the first tranche, the working capital amounts were required to be expended for the acquisition, construction, and/or substantial improvement of tangible property in an opportunity zone. The second tranche broadened this requirement to include the development of a trade or business in an opportunity zone. The following expenditures can be included in the development of a trade or business:

- Identifying new locations for the business in the opportunity zone;

- Leasing of a building for the business;

- Acquiring equipment and furniture for such building;

- Making necessary security deposits for the business;

- Obtaining a franchise and local permits;

- Hiring and training staff;

- Research and development expenses in the creation of an asset for the business; and
- Costs to develop property for the business.

Multiple Cash Contributions from a Qualified Opportunity Fund to the Opportunity Zone Business

The second tranche clarified that an OZB can obtain multiple overlapping or sequential cash contributions from QOFs and each separate cash contribution can obtain status as reasonable working capital with a separate 31-month expenditure period by independently satisfying the requirements of a separate written plan. Still, it is questionable whether a QOF can make additional cash contributions to the OZB and obtain a new 31-month expenditure period after the development that was part of an original written plan has been completed by the OZB where the newly contributed proceeds will be used only for operational expenditures (and not for development purposes).

Specifically, in the case of an OZB constructing and leasing real estate, can a new contribution of cash from a QOF be treated as reasonable working capital under this safe harbor where the cash will be used to fund long-term operating deficits over a 31-month period once the building has been constructed, is fully leased, and is operational? Also, in the case of an OZB operating a business with an employees, can a new contribution of cash from a QOF be treated as reasonable working capital under this safe harbor where the cash is going to be used to pay administrative expenses over a 31-month period once the business contemplated in the original written plan has already been developed, is now operational, and is being carried on?

The safe harbor provides that the working capital assets must be held for the development of a trade or business, or when appropriate, the acquisition, construction and/or substantial improvement of tangible property. Further, the written schedule in the written plan is supposed to be consistent with the ordinary start-up of a trade or business, and these trades and businesses are no longer in start-up mode. Accordingly, it is possible that subsequent contributions made by a QOF to the OZB once the OZB is past the development stage (or the construction and development stage for real estate) will not qualify as reasonable working capital under the described safe harbor.

Real Property Straddling an Opportunity Zone

For purposes of the 50% gross income requirement, the intangible property requirement, the NQFP requirement, and certain related safe harbors, when it is necessary to determine whether services, tangible property or business functions are located in an opportunity zone, real property located outside of the opportunity zone, but contiguous to real property located within the opportunity zone, is deemed to be located in the opportunity zone where certain requirements are met. Specifically, the amount of real property, based upon square footage located within the opportunity zone, must be substantial as compared to the amount of real property based upon square footage located outside the opportunity zone.

This could be helpful where an OZB is trying to satisfy any of the safe harbors for the 50% gross income requirement.

For example, an OZB owns a single building located within and without an opportunity zone consisting of a manufacturing facility, a warehouse and some office space. The manufacturing facility and the warehouse portions comprise over 90% of the square footage of the building and land and such portions are located within an opportunity zone. The office space portion of the building is located in a contiguous population census tract, but such census tract is not within an opportunity zone

The highly compensated employees are all located in the portion of the building consisting of office space and such individuals perform 100% of their services for the OZB in the office. The salaries paid to the individuals working in the office portion of the building represent more than 50% of the services performed for the trade or business in a taxable year, based upon the amounts paid to all employees and independent contractors. The OZB also leases a small building in another state located outside of an opportunity zone used for back office functions. The employees working inside this leased building comprise more than 50% of the total hours worked for the OZB by all employees and independent contractors in a taxable year.

By including the office portion of the building as being in an opportunity zone, the OZB could satisfy the safe harbor that at least 50% of the services performed for the trade or business, based upon the amounts paid, are performed in an opportunity zone in a taxable year. It does not appear that the OZB would satisfy the other two safe harbors.

Conclusion

The second tranche is very technical and complicated. It is obvious that the Department of the Treasury tried to be very flexible and taxpayer friendly here but were also cognitive of potential abuses. As a result, comments to be submitted to the Treasury Department and the IRS may want to suggest different approaches to prevent these potential abuses.

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