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INSIGHT: An Unexpected Gift in Opportunity Zone Correcting Amendments—Did This Really Just Happen?

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Treasury and the Internal Revenue Service recently issued correcting amendments to the final opportunity zone regulations. The corrections are effective on April 1, 2020, and applicable as of Jan. 13, 2020. While, in most cases, correcting (or ''technical'') amendments to regulations do not make substantive changes, this set of correcting amendments does. This article is not a review of all of those changes but, instead, focuses on one very significant sentence added to the regulations.

By way of background, pursuant to the OZ program, a taxpayer invests eligible gain into a qualified opportunity fund (QOF). At least 90% of a QOF's assets must be qualified opportunity zone property (QOZP). QOZP includes (1) qualified opportunity zone (QOZ) stock, (2) QOZ partnership interests, and (3) qualified opportunity zone business property (QOZBP).

In order for a QOF's equity interest in another entity to be considered QOZ stock or a QOZ partnership interest, the entity must be a qualified opportunity zone business (QOZB). There are several requirements that apply to determine whether an entity is a QOZB. One of those requirements provides that substantially all (at least 70% under the regulations) of the tangible property owned or leased by the QOZB must be QOZBP. The final regulations refer to this requirement as the ''70-percent tangible property standard.''

Whether a trade or business of the entity satisfies this 70% tangible property standard is determined by using a fraction, the numerator of which is the total value of all QOZBP owned or leased by the QOZB and the denominator of which is the total value of all tangible property owned or leased by the QOZB, whether located inside or outside of a QOZ.

Application of this 70% tangible property standard is particularly problematic in the start-up period in the following common scenario:

- a potential QOZB owns unimproved land in a QOZ that is not QOZBP because it was (1) contributed, (2) purchased from a related party, or (3) purchased prior to 2018;
- a QOF intends to invest into the entity and the cash will be used to construct a building on the land;
- the land is a bad asset and, therefore, makes it difficult (or impossible) for the entity to pass the 70% test until and unless the value of the work in progress is equal to 70% of the total value of its tangible property.

There are several additional requirements applicable to QOZBS, one of which is that less than 5% of the average of the aggregate unadjusted bases of property held by the entity can be attributable to nonqualified financial property (NQFP). Under tax code Section 1397C(e), the definition of ''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. The OZ regulations provide a working capital safe harbor (WCSH) that applies for purposes of applying Section 1397C(e)(1) to the definition of a QOZB.

The regulations also provide several other safe harbors (often referred to as ''secondary safe harbors'') that apply during a valid WCSH period.

In the correcting amendments to the final regulations, Treasury reorganized the section of the regulations relevant to the secondary safe harbors, created a new subsection entitled ''safe harbor for working capital and property on which working capital is being ex-

pended,'' and added provisions relevant to working capital.

The correcting amendments added the following highly impactful sentence under a new subsection entitled ''working capital:''

''If paragraph (d)(3)(iv) of this section treats property of an entity that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraphs (d)(3)(v)(A) through (C) of this section, *the entity* satisfies the requirements of section 1400Z-2(d)(2)(D)(i) only during the working capital safe harbor period(s) for which the requirements of paragraphs (d)(3)(v)(A) through (C) of this section are satisfied; however, such property is not qualified opportunity zone business property for any purpose.'' [emphasis added; Treasury Regulation 1.1400Z2(d)-1(d)(3)(vi)(D)(1)]

The first part of this sentence technically states that if there is a valid WCSH in effect (i.e., property of an entity that would otherwise be nonqualified financial property is treated as reasonable working capital because the WCSH requirements are met), then the *entity* satisfies the *QOZBP* requirements (i.e., the requirements in Section 1400Z-2(d)(2)(D)(i)) for the duration of the WCSH period. What exactly does this mean? The requirements in Section 1400Z-2(d)(2)(D)(i) are specifically applicable to tangible property—not to an entity. They apply to determine whether tangible property used in a trade or business is treated as QOZBP.

What does it mean to state that the entity meets the QOZBP requirements during a valid WCSH period? The Section 1400Z-2(d)(3)(A)(i) requirement (the 70% tangible property standard) essentially incorporates the Section 1400Z-2(d)(2)(D)(i) requirements (QOZBP requirements), because it mandates that 70% of a QOZB's tangible property be QOZBP.

Thus, it appears that the best interpretation of the new sentence in the correcting amendments is that during a WCSH period, an entity meets the Section 1400Z-2(d)(3)(A)(i) 70% tangible property standard by meeting the Section 1400Z-2(d)(2)(D)(i) QOZBP requirements. By stating that an entity is treated as meeting the QOZBP requirements while a valid WCSH is in effect, the regulations are actually stating that the entity meets the 70% tangible property standard—which means that the 70% tangible property standard is suspended during a valid WCSH period.

The impact of this addition in the correcting amendments cannot be overstated. If the tangible property standard is suspended during a WCSH, as long as a QOZB has cash that is protected by a WCSH, the fact that it has assets that are non-QOZBP (e.g., contributed property, property purchased prior to 2018, property purchased from a related party) does not preclude the entity from meeting the QOZB qualifications during the WCSH period.

In fact, even if, on a QOF's testing date, all a QOZB owns is non-qualifying property, the QOF's interest in the QOZB will be considered good property for purposes of the 90% investment standard as long as the QOZB has a valid WCSH in effect. This approach is consistent with the intent behind the OZ program. If the intent is to infuse new capital into a QOZ, it should not matter whether the property on which that capital is being expended (whether it is unimproved land or a building being renovated/rehabilitated) is *itself* good property. The change provides a true runway or start-up period for entities intending to function as QOZBs.

Example: A partnership that intends to qualify as a QOZB owns a piece of unimproved land in a QOZ that it purchased on Nov. 1, 2017. On Feb. 15, 2020, a QOF invests $10 million of cash into the entity in exchange for an equity interest. The entity has a written plan for use of that $10 million within 31 months of the date of contribution to construct a building on the land that will eventually be used in the active conduct of a trade or business. The entity substantially complies with that written plan. The entity meets the 70% tangible property standard, regardless of whether the only tangible property the entity owns on a particular QOF testing date is the unimproved land (which does not meet the QOZBP requirements absent the secondary safe harbor because it was purchased prior to Jan. 1, 2018).

In addition, the suspension of the 70% tangible property standard solves the zero over zero tangible property issue that could have arisen if a QOZB held only cash; there was some concern among practitioners that an entity could not meet the 70% standard if all it held was cash. This is no longer a concern if the 70% standard is deemed to be satisfied during a WCSH period. Of course, as soon as there is no longer a valid WCSH in place, an entity will have to meet the 70% tangible property standard.

As stated above, it is rare for such a significant substantive change to be made in correcting amendments, but this appears to be exactly what happened here. There is some confusion and debate among practitioners as to whether this is the case, but informal conversations with both the IRS Office of Chief Counsel and Treasury have confirmed the intent to provide this safe harbor and suspend the 70% tangible property standard during a valid WCSH period. At least one of the Big Four accounting firms is advising clients that this interpretation is a valid one and was the intended result. Unfortunately, there are additional regulatory provisions that add to the confusion surrounding this issue, discussed in more detail below.

The second part of the sentence added by the correcting amendments provides that working capital is not qualified opportunity zone business property for any purpose. [Treas. Reg. 1400Z2(d)-1(d)(3)(vi)(D)(1).] Why did Treasury add this? Prior to the correcting amendments, there was debate among practitioners as to whether working capital covered by a WCSH was treated as QOZBP. In other words, did the WCSH create *fictitious* tangible property equal to the cash that would be expended on that property for acquisition/construction/renovation pursuant to the working capital plan—property that existed for purposes of the 70% tangible property standard from day one of the WCSH? It was difficult to take this position based on the language in the regulations but language in the preamble to the final regulations caused confusion with respect to this issue. The preamble stated:

''The final regulations also clarify that unexpended amounts of working capital covered by the 31-month WCSH are not, following the conclusion of the final safe harbor period, treated as tangible property for purposes of applying the 70-percent tangible property standard.''

This language implied that the working capital covered by the safe harbor *was* treated as tangible property during the WCSH period. However, that was not stated

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in the regulations and the ''clarification'' referred to in the preamble was not made in the final regulations.

The language added to the correcting amendments makes it clear that working capital itself is never treated as QOZBP for any purpose—it is *not* treated as a fictitious asset that exists during a WCSH period. It is not treated as a proxy for the tangible property that the entity is constructing or improving. It is not taken into consideration in the 70% calculation.

This is the right answer. There is nothing in the regulations that can be interpreted as transforming cash into tangible property in this circumstance. Nowhere does the regulation say that the entity is treated as owning tangible property from day one of the WCSH with a value equal to the amount of cash that will be expended on that property pursuant to the WCSH.

However, the fact that Treasury also added the suspension of the 70% tangible property standard in the correcting amendments begs the question, why did they need to clarify that working capital is never QOZBP? If the 70% tangible property standard is suspended during a WCSH period, an entity would not need to treat working capital as QOZBP; the entity does not have to concern itself with QOZBP until it no longer has a valid WCSH in effect. So, under what circumstances is this provision regarding working capital in the correcting amendments relevant? It is not entirely clear. The provision appears to be unnecessary but Treasury may have felt that due to the prior debate it wanted to make the point crystal clear.

What is more problematic is the fact that Treasury chose to continue to include Treas. Reg. 1.1400Z2(d)-1(d)(3)(vi)(D)(2). That regulation provides that if a valid WCSH is in effect and, as a result of the expenditure of working capital under that safe harbor, tangible property is expected to satisfy Section 1400Z-2(d)(2)(D)(i) (the three QOZBP requirements) then tangible property that is purchased, leased, or improved by the trade or business pursuant to the working plan is treated as QOZBP during the WCSH period and subsequent WCSH periods that the property is subject to (up to 62 months). Why is this provision still in the regulations?

The sentence added to Treas. Reg. 1.1400Z2(d)-1(d)(3)(vi)(D)(1) that suspends the 70% tangible property standard by treating an entity as satisfying the QOZBP requirements during a valid WCSH renders this provision superfluous. If a QOZB is not applying the 70% tangible property standard during a valid WCSH period, why would it matter whether the tangible property being purchased, leased, or improved pursuant to that WCSH is treated as QOZBP during that period?

As stated above, informal conversations with both the IRS Office of Chief Counsel and Treasury have confirmed the intent to suspend the 70% tangible property standard during a valid WCSH period. However, practitioners are left with regulatory language that is at best confusing and at worst unable to be applied in a way that makes logical sense. It is a basic tenet of statutory construction that a provision should not be interpreted in a way that renders another provision redundant or meaningless.

On the other hand, there has to be a reason why Treasury added the new subsection and the language stating that an entity meets the QOZBP requirements during a valid WCSH period. What else could this mean if not that the entity meets the 70% tangible property standard? Query why Treasury could not have deleted Treas. Reg. 1.1400Z2(d)-1(d)(3)(vi)(D)(2) (to avoid confusion) and stated in a more straightforward way that the 70% tangible property standard is inapplicable during a valid WCSH period.

Treasury appears to have given taxpayers a gift in the suspension of the 70% tangible property standard but it remains to be seen whether most practitioners (1) realize that this is what they have done, and/or (2) feel comfortable enough with this regulatory interpretation to issue an opinion that the 70% tangible property standard can be ignored during a valid WCSH period.

Conversations with numerous practitioners have made it clear that there is widespread confusion regarding this potentially game-changing addition to the regulations. Formal clarification and an example are badly needed.

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