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The Eagerly Awaited Opportunity Zone Regulations: What Do They Tell Us and What Do We Still Need to Figure Out?

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On October 19, 2018, the Internal Revenue Service issued highly anticipated proposed regulations on opportunity zones. The regulations address several issues that are fundamental to the initial investment in and creation of a qualified opportunity fund (QOF). They also address issues related to the original use and substantial improvement tests, the definition of a qualified opportunity zone business, including reasonable working capital rules, and how debt is treated in a QOF taxed as a partnership. The IRS contemporaneously issued Rev. Rul. 2018-29 that addresses the application of the original use and substantial improvement tests to the purchase of land with an existing building in an opportunity zone as well as a draft QOF self-certification form (Form 8996) and accompanying instructions.

There are still a number of significant questions that remain unanswered, particularly in the context of the application of the penalty to QOFs, the definition of qualified opportunity zone business property, the tax consequences of the sale of an asset by a QOF or a subsidiary of a QOF, and issues surrounding the exit of investors from a fund. The Treasury Department and the IRS are aware of the need for additional guidance. The Office of Information and Regulatory Affair's unified agenda now lists a second regulatory project on opportunity zones to be completed by the end of the year.

This first set of regulations is a solid start. Perhaps the most significant message in the regulations is that Treasury and the IRS recognize the tremendous potential this program has to make a meaningful economic impact on the areas designated as opportunity zones. This message is evidenced by the practical approach of these regulations to encourage investment in opportunity zones consistent with the intent of the statute. The guidance and interpretations in these regulations provide a clearer path for investment in QOFs. So, although practitioners and clients are still left with uncertainty regarding several aspects of the program, the fact that the positions taken in these proposed regulations generally facilitate QOF investments provides a level of confidence that the next set of guidance will take the same approach and provide additional answers that support and encourage investment.

It is also very helpful that, unlike most proposed regulations, taxpayers are **allowed to rely on these proposed regulations** as long as certain requirements are met. That will allow investors, fund managers, real estate developers, and business owners to move forward with confidence.

After a brief introduction to the basics of the opportunity zone rules, this article focuses on the questions addressed in this first set of regulations. It also highlights and discusses several of the issues that remain open and offers suggestions as to how those questions may be answered in the guidance promised by the end of the year.

PART I — THE BASICS

What Are Opportunity Zones?

The concept of an ''opportunity zone'' was added to the tax code by the 2017 tax act.

An opportunity zone is a population census tract that meets the definition of a ''low-income community'' (as that term is defined under tax code §45D(e) in the context of the New Markets Tax Credit (NMTC)) and has been specifically designated as a qualified opportunity zone (QOZ) under §1400Z-1. IRS Notice 2018-48 includes an official list of all

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population census tracts designated as QOZs. There are now over 8,700 certified QOZs in all 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands.

The designation of a census tract as a qualified opportunity zone remains in effect for the period of time beginning on the date of that designation and ending on December 31 of the tenth calendar year beginning on or after the date of designation (i.e., December 31, 2028).

Congress refers to the opportunity zones program as an economic development tool. That is, the designation of these low-income communities as QOZs is intended to incentivize the movement of capital into these designated areas to develop property and create and expand businesses in an effort to reduce poverty and increase employment.

The incentive is accomplished by offering taxpayers who invest in these QOZs (through specific investment vehicles referred to as Qualified Opportunity Funds) and hold the investment for certain prescribed periods of time significant benefits including gain deferral, forgiveness of a portion of the deferred gain, and exclusion from gain for post-acquisition appreciation in the investment.

What Are the Tax Incentives for Investment in an Opportunity Zone?

Pursuant to this new tax incentive, if a taxpayer (1) realizes gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer, and (2) invests all or a portion of that realized gain into a ''qualified opportunity fund'' (QOF) within 180 days of the realization event, the taxpayer is able to elect to defer the invested gain until the earlier of (a) the date that the taxpayer sells or exchanges the investment in the QOF, or (b) December 31, 2026, at which point the taxpayer recognizes the lesser of (a) the fair market value of the investment over basis, or (b) the deferred gain over basis. Thus, the latest that the deferred gain is required to be recognized is December 31, 2026.

In addition, the following special rules apply:

- The taxpayer's initial basis in the investment in the QOF is zero;
- If the taxpayer holds the investment in the QOF for at least five years, the taxpayer's basis in the investment is increased by an amount equal to 10% of the gain that the taxpayer originally elected to invest and defer (which means that 10% of the deferred gain is permanently excluded);
- If the taxpayer holds the investment in the QOF for at least seven years, the taxpayer's basis in the investment is further increased by an amount equal to 5% of the gain that the taxpayer originally elected to invest and defer (which means that 15% of the deferred gain is permanently excluded);
- If the taxpayer holds the investment in the QOF for at least 10 years, the taxpayer can elect to have basis equal fair market value (FMV) on the date the investment is sold or exchanged (which means that post-acquisition gain is permanently excluded).

Note that there are essentially **three separate tax benefits — (1) temporary deferral; (2) permanent exclusion of a portion of the deferred gain (for investments held five or seven years); and (3) permanent exclusion of post-acquisition appreciation in the investment (for investments held 10 years).**

There is no statutory limit to the amount of realized gain that a taxpayer can obtain through investment in a QOF.

Example: On August 1, 2018, Taxpayer realizes a $100 million dollar capital gain on the sale of an asset. For purposes of this example, assume that the entire $100 million is eligible to be invested in a QOF. On September . 1, 2018, Taxpayer invests that $100 million in a QOF and affirmatively elects to defer the gain. Taxpayer's initial basis in the QOF investment is zero. Taxpayer continues to hold the investment. On September 1, 2023, Taxpayer's basis in the QOF increases to $10 million (10% of the deferred gain). On September 1, 2025, Taxpayer's basis in the QOF increases to $15 million (15% of the deferred gain). On December 31, 2026, in spite of the fact that Taxpayer has not yet sold the investment in the QOF, Taxpayer is required to recognize the lesser of (a) the FMV of the investment over basis, or (b) the deferred gain over basis. Assume that on December 31, 2026, the FMV of the QOF interest has appreciated to $140 million. Thus, Taxpayer recognizes $85 million ($100 million deferred gain minus $15 million basis) of capital gain on December 31, 2026. Taxpayer's basis in the investment is increased by the $85 million gain recognized to $100 million. On September 1, 2028, Taxpayer sells the QOF investment for its FMV, which is then $150 million. Because Taxpayer has held the investment for 10 years, Taxpayer is able to elect to have basis equal FMV and recognizes no gain on the sale.

Only the invested ''gain'' is eligible for the special tax benefits. A taxpayer is free to invest more than the gain realized (e.g., the entire amount realized), but the tax benefits are available only with respect to an investment made with deferred gain. If the taxpayer in-

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vests both deferred gain and other funds, the investment is treated as two separate investments, one to which the tax benefits apply and one to which they do not.

Example: On August 1, 2018, Taxpayer sells stock for $150 million. Taxpayer's adjusted basis in the stock is $50 million. The amount realized is $150 million; the gain realized is $100 million. The $100 million is eligible for the tax benefits afforded investment in a QOF. If the Taxpayer invests all $150 million into a QOF, only $100 million of it is eligible for the tax benefits. The Taxpayer will be treated as having two separate investments in the QOF — a $100 million investment with a basis of zero (which is eligible for the basis step-ups at five and seven years and the post-acquisition gain exclusion at 10 years) and a $50 million investment with a cost basis of $50 million (which is not eligible for any special tax benefits).

Although the general mechanics of the opportunity zone provisions seem straightforward, the way in which the statutory language was written left open a multitude of questions regarding almost every aspect of the program. There has been widespread interest and excitement about the incentives to invest that this new program presents but, in many cases, taxpayers have been unable or unwilling to pull the trigger on creation of a QOF or investment in an opportunity zone because there were simply too many uncertainties. Alternatively, taxpayers have moved forward but have had to make assumptions and accept some level of risk that those assumptions prove right.

The October 19 proposed regulations provide a numbers of answers and are discussed in detail in Part II, below.

PART II — QUESTIONS THAT THE OCTOBER 19 PROPOSED REGULATIONS (and the Revenue Ruling and draft form and instructions) ANSWER

Investment in a QOF

What type of gain is eligible for deferral?

The proposed regulations clarify that only ''capital gain'' is eligible for deferral through investment in a QOF. The regulations define a gain eligible for deferral as any gain that is treated as capital gain for federal income tax purposes. So, any gain that a taxpayer is required to include in its computation of capital gain (including capital gain from an actual or deemed sale or exchange) is eligible to be deferred. Thus, both short-term and long-term capital gain is eligible for deferral. In addition, §1231 gain (gain from the sale of real estate used in a trade or business) and unrecaptured §1250 gain (which is ''capital gain'' taxed at a higher capital gains rate) are eligible for deferral. However, §1245 and §1250 depreciation recapture, which is taxed as ordinary income instead of being included in the taxpayer's computation of capital gain, is not eligible for deferral.

Note that capital gain from a sale or exchange with a related person is not eligible for deferral. There is a modified definition of ''related party'' that applies for purposes of this rule. That modification changes the 50% threshold for prohibited common ownership to 20% (each time it appears in §707(b)(1) and §267(b)).

How does the deferral rule apply in the context of §1256 contracts?

The proposed regulations include a few rules specific to §1256 contracts. The regulations provide that a taxpayer is allowed to defer only the capital gain net income from §1256 contracts for a given taxable year. In other words, the deferral of capital gain from §1256 contracts is available only on an aggregate basis. The 180-day period for investment of such capital gain net income begins on the last day of the taxable year. In addition, there can be no deferral of gain from a §1256 contract if, at any time during the taxable year, the contract was part of an ''offsetting-positions transaction'' in which any of the other positions was not also a §1256 contract. The regulations provide a definition of an ''offsetting-positions transaction.''

Who is the "taxpayer" that is able to elect deferral and invest in the QOF?

The proposed regulations provide that any taxpayer that recognizes capital gain for federal income tax purposes is a taxpayer eligible to elect deferral under the opportunity zone rules. Thus, individuals, C corporations (including a regulated investment company (RIC) or real estate investment trust (REIT)), partnerships, S corporations, and trusts or estates are all eligible to defer gain through investment in a QOF.

What about gain from pass-through entities?

Under the proposed regulations, with respect to eligible capital gains from a sale or exchange of an asset by a partnership (or other pass-through entity), either the partnership can elect to defer all or part of the gain or, to the extent that the partnership does not so elect, the partner(s) to whom the entity allocates such capital gain may elect to defer all or part of the gain.

If the partnership is making the election to defer, the 180-day period for the partnership begins on the date that the partnership sells or exchanges the asset

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and realizes the gain. If a partner is going to elect to defer the gain, the default rule is that the partner's 180-day period does not begin until the last day of the partnership taxable year in which the realization event occurred — which is the date on which the partner ''recognizes'' its allocable share of the gain absent an election to defer. As an alternative, the partner may elect to treat the partner's own 180-day period as being the same as the partnership's 180-day period (thus, it would begin on the date of the realization event).

These rules apply to other types of pass-through entities as well (including S corporations, trusts, or estates).

The approach in the proposed regulations allows partners (and other pass-through owners and beneficiaries) significant flexibility with respect to the timing of an investment of deferred gain in a QOF. As an example, if a calendar year partnership sells an asset on January 5, 2019, and does not elect to defer the gain, a partner may elect to defer its allocable share of the gain by investing it any time between that date and July 4, 2019, or any time between December 31, 2019, (the date the partner recognizes its allocable share of the partnership gain) and June 28, 2020.

How does a taxpayer make a deferral election?

As of now, the IRS anticipates that a taxpayer will make a deferral election on Form 8949 and will attach that form to the taxpayer's federal income tax return for the taxable year in which the taxpayer would have recognized the gain if the taxpayer had not elected deferral.

Is a taxpayer allowed to make multiple elections, within 180 days, with respect to various parts of the gain from a single sale or exchange of property?

Yes. The proposed regulations clarify that the provision in the statute that prohibits an election with respect to a sale or exchange if there is a previous election with respect to that sale or exchange in effect is intended to prevent a taxpayer from making multiple elections with respect to the **same** gain but does not prohibit a taxpayer from making multiple elections with respect to various portions of gain from a sale or exchange. As an example, if a taxpayer realizes a $10 million capital gain from the sale of an asset on June 1, the taxpayer can elect to defer $2 million on July 1 through investment in a QOF and can also elect to defer $8 million on that same day through investment into a different QOF, or could elect to defer $8 million on a later date that is no more than 180 days from June 1 (e.g., August 1) into the same or another QOF. In other words, the taxpayer's election with respect to the $2 million capital gain does not prevent the remaining $8 million of gain from being considered ''eligible gain'' that the taxpayer may elect to defer.

Are the tax attributes of the capital gain deferred through investment in a QOF preserved?

Yes. The proposed regulations provide that all of the deferred capital gain's tax attributes are preserved. Thus, the character of capital gain as short-term versus long-term or as §1250 gain, etc. is retained and applies when the taxpayer reports the gain.

What type of investment of eligible gain in a QOF qualifies for the tax benefits under the opportunity zone rules?

The investment in a QOF must be an equity interest in order to qualify for the tax benefits. Thus, debt does not qualify.

The proposed regulations clarify that an equity interest includes preferred stock as well as a partnership interest with special allocations. This is an important provision because it allows the use of capital structures that provide non-pro rata distributions, which are fairly common. There was some concern these types of capital structures would not be allowed under the opportunity zone rules.

Is a taxpayer able to use an eligible interest in a QOF as collateral for a loan without jeopardizing the tax benefits?

Yes. The proposed regulations allow a taxpayer that is an owner of an eligible interest in a QOF (an interest to which the tax benefits apply) to use that interest as collateral for a loan.

If a taxpayer invests both eligible capital gain (gain for which a deferral election has been made) and other funds into a QOF, is the election to step-up basis to fair market value available with respect to the gains realized on the investment of other funds?

No. The proposed regulations clarify that the basis step-up election (which allows a taxpayer to exclude post-acquisition gain on the sale of a QOF interest held for at least 10 years) applies only to a QOF investment made with eligible capital gain subject to a proper deferral election.

Is a taxpayer allowed to re-invest previously invested deferred gain?

Yes. The opportunity zone rules provide that if a taxpayer sells or exchanges an interest in a QOF (acquired in connection with a gain deferral election) prior to December 31, 2026, the taxpayer must generally include the previously deferred gain in income in the taxable year of that sale or exchange (referred to as an ''inclusion-triggering disposition''). The proposed regulations provide that a taxpayer can avoid

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this inclusion in income if the taxpayer re-invests the previously deferred gain through a new investment in a QOF (which the example states could be either the original QOF or another QOF). In order for this re-investment to qualify, (1) 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, and (2) the investor has to have disposed of the entire initial investment.

As an example, assume that Investor made an election to defer capital gain through investment in a QOF in 2019 and, on Feb. 1, 2022, Investor sells its entire interest in the QOF in a transaction that triggers inclusion of deferred gain in income. As long as Investor re-invests (in a QOF) the gain that would otherwise be included in income by July 31, 2022 (180 days from the inclusion-triggering disposition), the re-investment will qualify under the opportunity zone rules.

How does a taxpayer identify the QOF interest sold or exchanged if the taxpayer owns fungible (indistinguishable) interests that have different attributes (e.g., different holding periods)?

The proposed regulations provide that if a taxpayer owns fungible interests (indistinguishable interests (e.g., equivalent shares of stock or partnership interests with identical rights)) in a QOF that have different attributes and the taxpayer disposes of less than all of its interests on a single day, the taxpayer must identify the interest(s) disposed of using a first-in first-out (FIFO) method. If, after a taxpayer applies the FIFO method, a taxpayer is treated as having disposed of less than all of the investment interests the taxpayer acquired on a single day and those interests have different characteristics, the taxpayer will apply the pro rata method to determine which interests it disposed of.

The ability to use the FIFO method upon disposition of fungible QOF interests is significant in that, normally, a partnership interest is treated as a single unitary interest (with different holding periods, as appropriate). Thus, under the normal rule, if an investor in a QOF taxed as a partnership contributed eligible gain on Date 1, made an additional capital contribution on Date 2, and then sold half of its partnership interest on Date 3, the investor would be treated as having sold half of the investment with the Date 1 holding period and half of its investment with the Date 2 holding period. This general rule is significant in the context of opportunity zone investment because the opportunity zone tax incentives (other than the deferral itself) are based on the investors' holding periods (five, seven, and 10 years). However, under the proposed regulations, in certain circumstances, an investor that holds partnership interests with identical rights acquired over time will be able to use the FIFO method when and if the investor disposes of less than its entire interest.

There is, however, a continuing issue here. The use of the FIFO method in the proposed regulations seems to apply only to inclusion-triggering dispositions (dispositions prior to December 31, 2026) under §1400Z-2(a)(1)(B) and §1400Z-2(b). The proposed regulations allow the use of the FIFO method to determine three specific issues: (1) whether the investment was one to which the deferral election applied; (2) the attributes of the gain subject to a deferral election at the time the gain is included in income; and (3) the extent, if any, of an **increase in basis under §1400Z-2(b)(2)(B)** (which are the increases at five years and at seven years, but not the basis step-up election at 10 years). In all of the examples in the regulations, the sales occur prior to 2026 and the FIFO (and/or pro-rata method) are used to determine the resulting tax consequences on the inclusion of gain in income. Based on the way in which the regulations are currently written, it does not appear that a taxpayer is able to use the FIFO method when it comes to determining the 10-year holding period necessary for the basis step-up to fair market value in §1400Z-2(c), which means that if an investor has made fungible investments in a partnership QOF over time and sells less than all of its interest prior to the end of the 10-year period beginning on the date of the last investment, the investor will not fully qualify for the gain exclusion.

What is the effect of the sunset of the QOZ designation on December 31, 2028? Do the regulations clarify that a QOF investment made in 2019 or later and held for 10 years qualifies for post-acquisition gain exclusion and continues to qualify until sold?

Yes. The ability to make the election to increase basis to fair market value on sale of a QOF interest is not impaired by the expiration of the designation of the zone at the end of 2028. The proposed regulations allow a taxpayer to make this election for dispositions of qualifying investments (investments purchased with eligible gain subject to a deferral election) occurring after the 10-year hold and before January 1, 2048.

Under the proposed regulations the latest date on which an investor could make an investment of deferred gain to which the basis step-up election, applicable after a 10-year hold, would apply is **June 28, 2027**. This is because gain eligible to be invested in a QOF is gain that, if deferral were not allowed, would be recognized by the taxpayer no later than December 31, 2026. So, if a taxpayer has capital gain that would

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otherwise be recognized on December 31, 2026 and elects to defer that gain (which it would have to do by June 28, 2027), that investment would qualify for the gain exclusion benefit as long as the taxpayer held the investment until at least June 28, 2037. Note that the 180-day calculation is done using December 31, 2026 as Day 1. The statute states that the 180-day period begins on the date of the sale or exchange.

To the extent that an investor wants to take advantage of the exclusion of post-acquisition gain, the investor would have to sell or exchange the QOF interest by December 31, 2047. Treasury and the IRS are aware that this incentivizes an exodus from QOFs on or just prior to an essentially arbitrarily chosen date, which may or may not align with the best date to sell an interest, from a business or economic standpoint. There is a request for comments on whether there is a better way to handle the expiration of the availability of the basis step-up election. One suggested approach is to allow an investor to step-up basis without a disposition.

The QOF

In order for the opportunity zone tax benefits to apply, a taxpayer must invest the deferred realized gain in a QOF within the applicable 180-day period. A QOF is defined in the statute as an investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property (QOZP) and that holds at least 90% of its assets in QOZP. A QOF cannot invest in another QOF.

Can a QOF be an LLC taxed as a partnership or corporation?

In the definition of a QOF, the statute refers to an investment vehicle ''organized as'' a partnership or corporation (which could, arguably, preclude use of an LLC). The proposed regulations clarify that a QOF can be an LLC taxed as a partnership or corporation. The regulations provide that an entity is eligible to self-certify as a QOF if it is classified as a corporation or partnership for federal income tax purposes. Note that a QOF cannot be a single-member LLC because it would be a disregarded entity and not an entity classified as a partnership.

Is a QOF required to be created or organized in a particular state?

A QOF must be an entity organized in one of the 50 states, the District of Columbia, or a U.S. possession. If an entity is organized in a U.S. possession and not in one of the 50 states or the District of Columbia, the entity may be a QOF only if is organized in order to invest in QOZP that relates to a trade or business operated in the U.S possession where it is organized.

Can a pre-existing entity qualify as a QOF?

Yes. A pre-existing entity is able to self-certify as a QOF, but the pre-existing entity must satisfy the requirements under §1400Z-2(d), which means that it cannot own a significant amount of tangible property that it acquired prior to December 31, 2017.

How does an entity qualify as a QOF?

An entity is able to self-certify as a QOF by filing a self-certification form and attaching the form to its timely filed federal income tax return (taking into account extensions) for the taxable year. An entity does not need to go through any specific approval process or vetting process in order to be considered a QOF. The IRS issued a draft self-certification form (new Form 8996, *Qualified Opportunity Fund*) and instructions. The IRS expects that a QOF will attach this form to its federal tax return for all relevant tax years and will use this form to self-certify and also to annually report compliance with the 90/10 test.

The proposed regulations provide flexibility to funds by allowing an eligible entity to identify the first month in the initial taxable year in which the entity wants to be a QOF, which does not have to be the date the fund was created. So, a fund can be created and can begin certain processes (such as permitting, etc.) and then choose a later month on its self-certification, right before the first investment of deferred gain is made, to be considered a QOF — and that later month is when the first testing period begins. This allows a QOF to prevent the six-month testing period from beginning to run until there is deferred gain invested in the fund, while still allowing the QOF to initiate activities essential for future investment.

According to the draft of both Form 8996 and the instructions, by the end of the first QOF year, the organizing documents of the QOF are required to include a statement that the purpose of the entity is to invest in QOZP and are also required to include a ''description of the qualified opportunity zone business(es) that the QOF expects to engage in either directly or through a first-tier operating entity.'' Interestingly, the assumption in these draft documents is that a QOF will be engaging in a qualified opportunity zone business (QOZB) either directly or indirectly through an equity interest in a subsidiary. However, the rules allow a QOF to own qualified opportunity zone business property (QOZBP) directly and/or own an equity interest in an entity that is a QOZB. Nowhere in the statute does it imply that if a QOF chooses to own QOZBP directly that the QOF itself is subject to the rules applicable to a QOZB or that the QOF must engage in a QOZB. The definition of a QOZB in the statute is only relevant in the context of a QOF's equity interest in qualified opportunity zone stock or a qualified opportunity zone partnership interest. In fact, if a QOF that owns assets directly was also required to be a QOZB, there would be conflict

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between application of the 90/10 test applicable to the fund and the substantially all test applicable to a QOZB (70/30 test).

What are the reporting requirements applicable to QOFs?

This question is partially answered in the draft Form 8996 and instructions. A QOF will self-certify by attaching that form to its tax return but will also have to fill out and attach that form for each year in which it is a QOF. The form requires information necessary to determine whether the 90/10 test is met and compute the penalty, if applicable. Treasury and the IRS have requested comments as to whether and to what extent there should be additional information-reporting requirements imposed on QOFs.

The 90% Test

At least 90% of a QOF's assets must be QOZP. QOZP includes (1) qualified opportunity zone stock (QOZ stock), (2) qualified opportunity zone partnership interests (QOZ partnership interests), and (3) qualified opportunity zone business property (QOZBP).

The statute provides that the 90% test is applied by determining the average of the percentage of QOZP held in the fund as measured on the last day of the first six-month period of the taxable year of the fund, and the last day of the taxable year of the fund. If a QOF fails to meet the 90% requirement and does not establish reasonable cause, the QOF is required to pay a monthly penalty of the excess of the amount equal to 90% of its aggregate assets, over the aggregate amount of QOZP held by the QOF multiplied by the underpayment rate in the tax code.

How are a QOF's assets measured for purposes of the 90/10 test?

The proposed regulations (and the draft instructions to Form 8996) provide that if a QOF files a financial statement with the Securities and Exchange Commission or another federal agency other than the IRS or if the QOF has an audited financial statement prepared in accordance with U.S. GAAP, the QOF measures will use the asset values as reported on its financial statement as the relevant value for the 90% test. If the QOF does not have a financial statement that meets these requirements, value will be based on the QOF's cost.

How does a QOF measure the first testing period?

The determination of the first testing period for a QOF is based on the first month in which the QOF self-certification is effective. If this is not the first month of the year, then the phrase ''first 6-month period of the taxable year of the fund'' means the first six months each of which is in the taxable year and in each of which the entity is a QOF. If a calendar-year entity becomes a QOF during the second half of the taxable year, the only testing date for that year would be the end of December. Regardless of how close to the end of the year the entity becomes a QOF, the last day of the taxable year is a testing date.

Month in which calendar-year eligible entity becomes a QOF:	First Testing period:	Second Testing Period:
January	End of June	End of December
March	End of August	End of December
October	End of December	End of June the following year

How does averaging work for purposes of the 90/10 test? Does the fund find the percentage at the end of the first testing period and the end of the taxable year and average the two? Or does the fund have to meet the test separately on each testing date?

The fund does not appear to have to meet the test separately on each testing date. Although the proposed regulations do not clarify the answer to this question, the draft Form 8996 does. Based on the questions and computations on that form, it appears that the QOF uses the average of the percentages of QOZP held at the end of the first six-month period and the end of the taxable year to determine whether there is a penalty imposed. On Form 8996 the QOF (1) computes the percentage of QOZP held on the last day of the first six-month period, (2) computes the percentage of QOZP held on the last day of the taxable year, (3) adds those two numbers, and (4) divides by two. If the result is equal to or more than .90, the penalty is zero. If the result if less than .90, the fund has to compute the penalty.

What is the effect of leverage in a QOF taxed as a partnership? How is the deemed contribution of cash treated under the opportunity zone rules?

Under the general rules of Subchapter K, when an entity taxed as a partnership borrows money, that liability is ''allocated'' to the partners. Section 752(a) treats any increase in a partner's share of partnership liabilities as a contribution of cash by the partner to the partnership. A partner's adjusted basis in a partnership interest is increased by the amount of cash that the partner contributes to the partnership. Therefore, a contribution of cash that is deemed to occur when a partner's share of partnership liabilities increases will, in turn, increase the partner's adjusted basis in its partnership interest in an amount equal to the deemed contribution.

When a QOF taxed as a partnership borrows, is the deemed contribution of cash by an investor (equal to the investor's allocated share of the liability) treated as a separate interest in the partnership that would not be eligible for the opportunity zone tax benefits (because it is not a contribution of deferred gain)? In

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other words, does the debt create a split interest for the investor? If so, the investments would need to be tracked separately and the interest related to the debt would not be eligible for the opportunity zone tax benefits. What this means is that the appreciation on the debt-financed portion of the QOF investment would not be eligible for gain exclusion.

In another pro-taxpayer interpretation, the proposed regulations provide that deemed contributions of cash to a QOF taxed as a partnership that occur when the QOF incurs debt do not create a separate interest in the fund (to which the opportunity zone tax benefits would not have attached). This is incredibly significant for investors in QOFs taxed as partnerships. Any other decision here would have created significant administrative complexity and could have limited the benefit of the eventual gain exclusion.

Definition of Qualified Opportunity Zone Business Property (QOZBP)

The definition of qualified opportunity zone business property (QOZBP) is pivotal regardless of whether a QOF invests in that property directly or does so through an equity interest in a partnership or corporation.

QOZBP is defined as tangible property used in a trade or business if:

(1) the property is acquired by purchase after December 31, 2017;

(2) EITHER (a) the original use of the property in the zone commences with the QOF (or the QOZB) or (b) the QOF (or QOZB) substantially improves the property; and

(3) during substantially all of the holding period for the property, substantially all of the use of the property is in the zone.

In order for property to be considered ''acquired by purchase'' it cannot be acquired from a related party. There is a modified definition of ''related party'' that applies for purposes of these rules. That modification changes the 50% threshold for prohibited common ownership to 20% (each time it appears in §707(b)(1) and §267(b)).

How does the original use and substantial improvement test apply to the purchase of land and a building?

In order to be considered QOZBP, tangible property must meet a ''use'' test. That test is met if either the original use in the zone commences with the QOF (or QOZB) or the QOF (or QOZB) substantially improves the property. The substantial improvement test is met if, during any 30-month period beginning after the date of acquisition of the property, additions to basis with respect to such property in the hands of the QOF exceed an amount equal to the adjusted basis of such property at the beginning of that 30-month period in the hands of the QOF (this has been referred to as ''doubling down'' because basis needs to be doubled).

The proposed regulations, coupled with Rev. Rul. 2018-29, create a clearer and more economically feasible path to the purchase and rehabilitation of an existing building in a zone by providing that if a taxpayer purchases land and a building, the land itself does not have to be separately ''improved'' and the basis in the land is not part of the basis that needs to be doubled in order to meet the substantial improvement test for the building. This should facilitate the rehabilitation of vacant buildings in opportunity zones.

Although this guidance is very helpful to a QOF or QOZB that is purchasing land with an existing building to be improved, it leaves open the question of how the original use and substantial improvement tests apply to a purchase of land (or land with a building to be demolished). This is discussed further in Part III, below.

Definition of Qualified Opportunity Zone Business (QOZB)

A QOF can own qualified opportunity zone business property (QOZBP) directly or can own an equity interest in a partnership or corporation that is a QOZB. If the QOF owns nothing but qualified opportunity zone stock or qualified opportunity zone partnership interests, then 100% of the assets owned by the QOF would qualify as QOZP as long as each of the entities in which the QOF is an owner meet the definition of a QOZB. Thus, it is imperative, for purposes of the QOF's ability to satisfy the 90/10 test, that its interests in subsidiary entities meet all of the definitional requirements applicable to a QOZB.

Qualified opportunity zone stock is defined as stock in a domestic corporation acquired by a QOF after December 31, 2017, at its original issue solely in exchange for cash if, as of the date of issue, the corporation is a QOZB (or, if the entity is a new corporation, is being organized for the purpose of being a QOZB) and during substantially all of the QOF's holding period for the stock, the corporation is a QOZB. In addition, rules similar to those in §1202(c)(3) apply.

A qualified opportunity fund partnership interest is defined as any capital or profits interest in a domestic partnership acquired by a QOF after December 31, 2017, from the partnership solely in exchange for cash

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if, at the time the interest is acquired, the partnership is a qualified opportunity zone business (QOZB) (or, if the entity is a new entity, is being organized for purposes of being a QOZB) and during substantially all of the QOF's holding period of the partnership interest, the partnership is a QOZB.

A QOZB is a trade or business that meets all of the following requirements:

(1) substantially all of the tangible property owned or leased by the partnership is QOZBP;

(2) at least 50% of the entity's total gross income is derived from the active conduct of the business;

(3) a substantial portion of the intangible property is used in the active conduct of the business;

(4) less than 5% of the average of the aggregate unadjusted bases of property is attributable to nonqualified financial property; and

(5) the business does not include operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, gambling establishment, or a store if the principal business is the sale of alcohol for consumption off premises.

Can a pre-existing entity be a QOF subsidiary (partnership or corporation) operating a QOZB?

Yes. A pre-existing entity can issue qualified opportunity zone stock or a qualified opportunity zone partnership interest and operate a qualified opportunity zone business. However, it is difficult for a pre-existing entity to meet the requirements of a QOZB due to the fact that a significant amount of its assets were likely acquired prior to December 31, 2017 (and, therefore, are not QOZBP). Treasury and the IRS have requested comments on how they can make it less difficult for existing entities to qualify as QOZBs.

Does QOZP include an interest in an LLC that is operating a QOZB?

Yes. The proposed regulations clarify that QOZP may include stock or a partnership interest in an entity classified as a corporation or partnership for federal income tax purposes. Thus, an LLC classified as a partnership or a corporation may be a QOF subsidiary.

How should a QOF's equity interest in a single-member LLC be treated and tested? A QOF's equity interest in a single-member LLC does not fit the definition of qualified opportunity zone stock or a qualified opportunity zone partnership interest because the single-member LLC is not classified as a corporation or a partnership. The entity would be disregarded and the QOF would be treated, for tax purposes, as the owner of the LLC's assets/business. Because a QOF is allowed to own QOZBP directly, this should not be an issue from a statutory perspective. However, it does raise an issue. Because the QOF is treated as the owner of the assets, the proper asset test under the statute would be the 90/10 test, not the tests applicable to a QOZB (which would be the 70/30 test, the active conduct test, etc.). In addition, as discussed below, the working capital safe harbor provided in the proposed regulations would not seem to apply because that safe harbor applies only to a QOZB. So, if investors in a QOF want the QOZB test and the working capital safe harbor to apply, it appears that a single-member LLC should not be utilized.

Is there a requirement that a QOF subsidiary be created or organized in a particular state?

A QOF subsidiary must be an entity organized in one of the 50 states, the District of Columbia, or a U.S. possession. If an entity is organized in a U.S. possession and not in one of the 50 states or the District of Columbia, the entity may be a QOF subsidiary only if the entity conducts a trade or business operated in the U.S possession where it is organized.

Is cash committed by a QOZB to a development project considered NQFP (subject to 5% rule) or is it considered "reasonable working capital"?

As discussed above, one of the requirements for qualification as a QOZB is that less than 5% of the average of the aggregate unadjusted bases of property held by the entity be attributable to nonqualified financial property (NQFP). Under §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 proposed regulations provide a practical and much-needed rule regarding reasonable working capital in the context of a QOZB. The regulations create a working capital safe harbor that applies to QOF investments in QOZBs that acquire, construct, or rehabilitate tangible business property (which includes both real property and other tangible property used in a business operating in an opportunity zone). As long as a QOZB has a written plan that identifies cash being held for a project and there is a written schedule for deployment of the cash that the business substantially complies with, the committed cash will be considered reasonable working capital for up to 31 months. The Treasury and the IRS have requested input as to whether the concept of reasonable working capital should be expanded beyond acquisition, construction, or rehabilitation of tangible business property to include development of business operations.

It is significant to note that the proposed regulations provide this safe harbor for a QOF investment in a

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QOZB, which, by definition, is a business operated by a first-tier operating subsidiary of a QOF. It is not entirely clear, however, whether the regulations are meant to limit this concept of reasonable working capital to QOF subsidiary entities. The preamble to the proposed regulations states that the concept of working capital was expanded in anticipation of ''situations in which **a QOF or operating subsidiary"** may need up to 30 months to substantially improve an asset. This suggests that the working capital safe harbor was intended to apply both to direct ownership of property by a QOF and indirect ownership of property through a subsidiary. This is another instance in this proposed guidance (in addition to the language in the draft Form 8996 and instructions (discussed above)) where there seems to be some confusion with respect to the application of the concept of a QOZB. The working capital safe harbor, by its terms, applies to QOF investments in QOZBs, which, by definition, are separate and distinct from direct QOF investments in QOZBP. Yet, as the language in the preamble suggests, the same safe harbor should be available to a QOF that directly acquires, constructs or rehabilitates QOZBP.

Does property that is in the process of "substantial improvement" qualify as QOZBP?

Yes. The proposed regulations provide that to the extent that the working capital safe harbor applies to a QOZB, the tangible property referred to in the written plan, which is expected to be QOZBP once completed, is not treated as failing to satisfy the QOZBP requirements solely because the work on the property is not completed.

What does "substantially all" mean with respect to the test that requires "substantially all" of a QOZB's assets to be QOZBP?

There is no definition of ''substantially all'' in the statute. The proposed regulations take the position that the ''substantially all'' threshold in §1400Z-2(d)(3)(A)(i) relevant to the percentage of tangible property owned or leased by a QOZB that must meet the definition of QOZBP is 70%. This decision will help maximize the economic impact of the opportunity zone program. As a point of reference, the substantially all threshold that currently applies in the context of the New Markets Tax Credit is 85%.

For purposes of valuing assets to determine whether a QOZB meets this threshold, the proposed regulations provide that if the entity has an applicable financial statement, the entity will use the values reported for the relevant reporting period on that statement. If the entity does not have an applicable financial statement, a taxpayer that is a QOF equity investor in the entity may value the entity's assets using the same methodology that the QOF uses to measure its own assets under the 90/10 test (the regulations refer to this as the ''Compliance Methodology''). However, this rule only applies if no other equity holder in the entity is a ''Five-Percent Zone Taxpayer.'' If the entity does not have an applicable financial statement and two or more taxpayers are QOF equity investors, at least one of which is a Five-Percent Zone Taxpayer, then the value of the entity's assets can be calculated by applying the Compliance Methodologies used by any QOF equity investor that is also a Five-Percent Zone Taxpayer and choosing the one that produces the highest percentage of QOZBP.

A ''Five-Percent Zone Taxpayer'' is an entity that has self-certified as a QOF and owns a 5% equity interest in the entity. The interest must represent at least 5% in voting rights and value if it is stock and at least 5% in value of the capital and profits of the entity if it is a partnership interest.

As an example, QOF A and QOF B each own 50% of the capital and profits interests in a partnership that operates a QOZB. QOF A does not have an applicable financial statement so it values its assets for purposes of the 90/10 test by using cost. QOF B does have an applicable financial statement so it uses the asset values on that statement to apply the 90/10 test. Using QOF A's compliance methodology (cost), 75% of the tangible property owned or leased by the partnership's QOZB is QOZBP. Using QOF B's compliance methodology (asset values on financial statement), 69% of the tangible property owned or leased by the partnership's QOZB is QOZBP. QOF A's methodology yields a higher percentage, so both QOF A and QOF B may use QOF A's methodology to value the QOZB's owned or leased tangible property.

Comparison of Direct QOF Ownership of QOZBP Versus Indirect Ownership of a QOZB

Before discussing the remaining open questions with respect to opportunity zones, it would be helpful to compare a QOF's direct ownership of QOZBP versus a QOF's ownership of an equity interest in a corporation or partnership that operates a QOZB. This is a foundational decision that each QOF must make and the ramifications of that decision could be quite impactful, based on the statute and this first set of regulations.

Query whether this disparity was the intended result. There does not seem to be any policy reason for the differences in treatment in most of these instances. Did Congress really intend for a QOF that owns assets directly to be able to operate a sin business? Is there a policy reason for a QOZB operated through a subsidiary to be allowed reasonable working capital but a QOF operating a business directly not to be?

There are a lot of inconsistencies that would be solved if the definition of a QOZB was also relevant

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QOF directly own QOZBP and operates business:	QOF owns an equity interest in a corporation or partnership operating a QOZB:
90/10 test (if QOF does not hold interests in subsidiaries, 90% of its assets must be QOZBP)	70/30 test relevant to QOZBP
No working capital safe harbor; absent further guidance, all cash would be counted toward the 10% of assets that can be non-QOZBP	Working Capital Safe Harbor applies to allow unlimited amount of cash as long as entity substantially complies with a written plan of deployment for acquisition, construction and/or rehabilitation
No active conduct standard	50% gross income from active conduct of trade or business (deemed to be met during construction/rehabilitation under working capital safe harbor)
All IP counts toward the 10% of assets that can be non-QOZBP	Can own an unlimited amount of IP as long as a substantial portion is used in the active conduct of a trade or business (deemed to be met during construction/rehabilitation under working capital safe harbor)
No prohibition on sin businesses	No sin businesses
No specific reference to the lease of property directly by a QOF	A QOZB is able to lease property and the statute contemplates that this property could qualify as QOZBP, but it is not clear how the QOZBP requirements are applied to leased property
As currently written, this 5-year grace period does not apply to QOZBP held directly by a QOF	Statute provides a 5-year grace period for characterization of property held by a QOZB as QOZBP

to a QOF that owned QOZBP directly and operated the business itself.

PART III — QUESTIONS THAT REMAIN UNANSWERED

Taxpayer Investment

Does a taxpayer have to realize gain outside of an opportunity zone in order for that gain to qualify for deferral once invested in a QOF?

There is no limitation in the statute providing that the gain deferred through investment in a QOF has to be realized outside of an opportunity zone. There should be no limitation on an investor's ability to sell an asset in an opportunity zone and invest the deferred gain either in another asset in that same zone or in another zone. Although this question is technically ''unanswered,'' the answer appears clear based on the statutory language.

Are there any exceptions to the 180-day rule?

Treasury and the IRS have requested comments on whether there should be exceptions to the general 180-day rule for investment of deferred gain into a QOF.

Does a taxpayer have to invest directly into a QOF or can an investment be indirect through another entity?

The statute contemplates direct investment into a QOF. However, in many types of transactions, the common structure includes the use of an entity between the investor and the fund, similar to the use of a syndicated fund in a NMTC deal. Hopefully, the second set of regulations will provide flexibility with respect to the ability to insert another entity between the investor and the QOF.

Can a taxpayer use a loan or a contribution of non-deferred gain to bridge the gap between a capital call and a realization event?

It is quite common for fund investors to be obligated to make contributions to capital over time. A taxpayer may or may not have realized gain available (or assets that it can quickly sell) at the time that a capital call is due. One solution could be to have the taxpayer loan funds into the QOF or QOF subsidiary that the taxpayer would replace with deferred gain when it is available. As long as when the taxpayer contributes the deferred gain, the taxpayer is treated as acquiring its interest for cash, this should meet the opportunity zone requirements. The QOF or QOF subsidiary can then use the contributed deferred gain to pay back the loan. It is also unclear whether a taxpayer can contribute cash that is not eligible for a deferral election and then replace it with deferred gain when it is available.

What types of transactions trigger inclusion of deferred gain?

Treasury and the IRS have requested comments on this question.

The QOF

Can a QOF invest in more than one opportunity zone property or businesses and/or opportunity zone property or businesses in different QOZs?

There is nothing in the statute precluding a QOF from investing in more than one opportunity zone project—either directly or through corporations or partnerships that are engaged in opportunity zone businesses nor is there anything precluding a QOF from investing in multiple opportunity zones. Although this question is technically ''unanswered,'' the answer appears clear based on the statutory language.

Is there any start-up grace period within which a QOF does not have to meet the 90/10 test?

Many commentators suggested a start-up grace period of at least 18 months from the time a QOF is formed before its first testing period would begin. This first set of proposed regulations does not provide a grace period. It remains to be seen whether Treasury and the IRS will provide one in the next set of regulations. If a QOF invests its cash in operating subsidiaries, this issue is alleviated as long as the subsidiary meets the working capital safe harbor. However, for a QOF that wishes to directly invest in QOZBP and operate a business in a zone, it could be very difficult to meet the 90/10 within such a short time absent addi-

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tional guidance on how cash will be treated at the QOF level.

Is there anything that the QOF is allowed to do with contributed cash prior to investment in QOZP? What is the timeframe within which a QOF is able to initially deploy invested funds?

These questions are similar to the one above, as is the answer. As of now, there is no guidance with respect to whether a QOF will be allowed a period of time in which cash is not counted against the QOF for purposes of the 90/10. Absent additional guidance, a QOF will have to either purchase QOZBP directly or invest in subsidiaries that meet the QOZB requirements before the expiration of the testing periods.

There is an exception from application of the penalty if the QOF can show that it had ''reasonable cause'' for failing the test, but, as discussed immediately below, there is no guidance on when or how this exception will apply.

What facts and circumstances will be sufficient to show "reasonable cause" for failing to meet the 90/10 test?

There is currently no guidance on this issue. There is guidance in the REIT context that could be helpful which provides that a REIT has reasonable cause to fail the gross income tests if the REIT exercised ordinary business care and prudence in its attempt to satisfy the tests. Under the regulations, reliance on a tax opinion rendered by a tax advisor generally constitutes ''reasonable cause.'' [Treas. Reg. §1.856-7(c)(2)].

How long does a QOF have to re-invest capital?

Section 1400Z-2(e)(4)(B) specifically authorizes regulations to make sure that a QOF has a ''reasonable period'' in which to re-invest the return of capital from investments in qualified subsidiaries and/or the proceeds from a sale or other disposition of QOZBP. Treasury has stated that the second set of regulations (due by the end of the year) will provide guidance on what constitutes a ''reasonable period'' for re-investment.

What are the tax consequences with respect to gains that a QOF re-invests? Are the gains deferred? Does the reinvestment by the QOF within a reasonable time period mean that the investors (if the QOF is a partnership) or the QOF (if QOF is a corporation) do not recognize any gain on the sale?

This is a significant issue because it will be very common for a QOF to sell assets and/or interests in subsidiary operating entities and the tax consequences of these sales are unclear. The statute clearly contemplates re-investment but is silent as to whether the re-investment is treated as continuous investment such that no gain is recognized. It is clear from the comments in the preamble to the proposed regulations that Treasury and the IRS understand the need for clarification but they need to provide this clarity in the context of a ''statutorily permissible possibility.'' In other words, it is not sufficient to regulate in a manner that is consistent with the intent of the statute if the regulation is counter to specific statutory language. So, in some cases, the ''clarification'' or fix to some of the issues in the statute may have to come from additional legislation.

QOZBP

How does the use test apply to the purchase of unimproved land (or land with a building to be demolished)?

The application of the use test is problematic in the context of a ground-up development on either unimproved land or land with improvements/structures that will not be part of the new development. In the case of this type of land acquisition, unless the IRS provides an exception or special rule, the land does not meet the original use test. According to Rev. Rul. 2018-29, ''given the permanence of land, land can never have its original use in a QOZ commencing with a QOF.'' That leaves the substantial improvement test. How is land substantially improved under this test when the construction of improvements on the land would not increase the QOF's basis in the land itself? It is possible that Congress intended that the phrase ''*additions to basis with respect to such property*'' be interpreted broadly so that ''such property'' is the entire purchased site and any improvements increase the overall basis ''with respect to'' that site, which includes the land. This is arguably a reasonable interpretation of such language and would accomplish what appears to be the goal of the legislation—to spur economic development (including ground-up development) in economically distressed areas. However, the description of the substantial improvement test in the regulations is slightly different — it refers to ''*additions to the basis of such property*,'' which is more restrictive.

It would certainly be in keeping with the intent of the opportunity zone program to take the position that unimproved or vacant land is essentially ignored for purposes of the use test and the improvements on that land are the QOZBP. This would be consistent with the approach taken by the IRS in Rev. Rul. 2018-29, which provides that when both land and a building are purchased and the building is improved, the land does not have to be separately improved and the basis of the land is not relevant to the substantial improvement test.

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Although this is technically an open issue, the proposed regulations do provide confidence that a purchase of land followed by construction on that land works under the opportunity zone rules. There is an example in the regulations (added to illustrate the working capital safe harbor) that describes a transaction in which an investor invests deferred gain into a QOF, which in turn invests the cash in a partnership. The partnership has written plans to acquire **land** in a qualified opportunity zone and to construct a commercial building on that land. The written plan provides that a portion of the cash will be used to acquire the land; a portion will be used to construct the building; and the remaining portion will be used for ancillary but necessary project expenses. As the partnership completes the building, its assets are the land, the unspent amounts in the working capital assets, and the work in process. The example provides that all of the cash is reasonable working capital and that the partnership meets all of the QOZB tests as it is developing the property such that the QOF's investment in the partnership is a qualified opportunity zone partnership interest for purposes of the 90/10 test.

Treasury and the IRS are soliciting comments on the application of the ''original use'' and ''substantial improvement'' tests and whether there are additional rules needed. They are aware of the need for additional clarification, not just with respect to land but also with respect to the definition of what constitutes ''original use,'' the application of the test to moveable tangible property, or underutilized or abandoned property, etc.

If land does not qualify as QOZBP because it was not "acquired by purchase after December 31, 2017," can the vertical improvements on the land qualify for opportunity zone investment?

As an example, assume that an investor is a current landowner in an opportunity zone. The land is not QOZBP because it was acquired prior to December 31, 2017. The investor, along with other investors, invests eligible deferred gain into a QOF that, in turn, invests the cash into a partnership. Assume that the landowner/investor cannot sell the property to the QOF or the partnership because of the related party rules. It does not want to divest itself of 80% or more of its ownership interest in the land. So, the landowner either contributes the land to the partnership or the partnership leases the land from the landowner. In either case, the land is not QOZBP. The partnership has a written plan to deploy the cash invested by the QOF to construct a low-income housing development on the property. The improvements are self-constructed separate depreciable tangible property acquired after December 31, 2017, and would meet the original use test. As long as all of the other requirements are met (e.g. the working capital safe harbor), the improvements should qualify as QOZBP. There is some concern that the improvements are ''tainted'' by the fact that they are built on land that does not qualify. That conclusion, however, does not seem to align with either the statutory and regulatory language or the policy behind the incentive.

The one issue that does arise is the fact that because the land itself is not QOZBP, the value of the land cannot be included in determining whether 70% of the partnership assets are QOZBP. Similar to the example in the regulations, as the partnership completes the construction, its assets are the land or a leasehold (which is not QOZBP), the unspent amounts in the working capital assets, and the work in process.

Can the 30-month substantial improvement period be extended if there are extenuating circumstances beyond the control of the QOF/QOZB?

There is no provision for extension as of yet.

Can property leased directly by a QOF be QOZBP?

Based on the statutory language, the answer appears to be no. However, this is another instance in which there is a significant difference in the provisions applicable to a QOF versus the provisions applicable to a QOF subsidiary and this may be remedied in the next set of regulations.

QOZBs

Does the five-year extension for characterization of property held by a QOZB as QOZBP also apply to QOZBP held directly by a QOF?

Based on the statutory language, the answer is no. However, as discussed above in the context of the arguably unintended differences between the provisions applicable to QOF direct ownership of QOZBP and the provisions applicable to QOF indirect ownership through a subsidiary, this question may be answered differently in the next set of regulations.

How does the QOZBP test apply to property leased by a QOZB?

Although the statute allows a QOF subsidiary operating a QOZB to lease property (it specifically refers to ''property owned or **leased**'' by such an entity), it is entirely unclear how that leased property is tested. In the context of a QOZB, the statute requires that substantially all of the tangible property owned or leased be QOZBP. As an example, if a QOZB leases a building in a zone in which it operates its business, that building is tangible property leased by the QOZB. Does that mean that the building itself has to be

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QOZBP and how would that work? The QOZBP tests in §1400Z-2(d)(2)(D) cannot be reasonably applied to tangible property that is leased, which begs the question how is leased property handled in the context of the ''substantially all'' test?

Does the leasing of residential rental property qualify as an active trade or business for purposes of the definition of a QOZB?

Section 1397C(d)(2) provides that a ''qualified business'' (in the context of enterprise zones) does not include the rental to others of residential rental property. The concern in the context of the opportunity zone program is whether this limitation applies there as well — i.e., whether leasing of residential rental property will be considered the active conduct of a trade or business for purposes of the QOZB tests. There is no specific reference to §1397C(d) in §1400Z-2. In fact, that section only refers to §1397C(b)(2), §1397C(b)(4), and §1397C(b)(8). The concept of a ''qualified business'' is contained in §1397C(b)(1), which provides that a ''qualified business entity'' is one in which every trade or business conducted is a ''qualified business'' (as defined in §1397C(d)). Section 1400Z-2 contains its own definition of a QOZB and refers to specific provisions in §1397C as a part of that definition. The language in §1397C(b)(2) (which **is** referred to in §1400Z-2) refers to the active conduct of ''such business'' which, in the context of §1397C, refers to the term ''qualified business'' as defined in §1397C(d). However, for purposes of the opportunity zone rules, the more logical interpretation of ''such business'' in §1397C(b)(2) would be a reference to a ''trade or business'' as defined in §1400Z-2(d)(3)(A). In other words, the reference to §1397C(b)(2) in §1400Z-2(d)(3)(A)(ii) is there to create an active conduct standard (50% of gross income) applicable to a QOZB and not to provide a definition of a qualified business.

In addition, it would be counter to the intent behind the opportunity zone program, which certainly includes a desire to provide additional affordable housing options in the designated zones, to take the position that the leasing of residential rental property cannot meet the definition of a QOZB.

It is worth noting that in Rev. Rul. 2018-29, which the IRS issued contemporaneously with the proposed regulations and deals with the application of the QOZBP use requirement to the purchase of land with a building, the relevant QOF is purchasing a factory building with the intent to convert the building to residential rental property. Although the reference to residential rental property in this ruling is promising in terms of the IRS's view of the use of a QOF to facilitate housing developments in opportunity zones, the ruling does not discuss QOZBs or the ''active conduct of a trade or business'' requirement in §1397C(d). Thus, the ruling cannot be used to take the position that the leasing of residential rental property satisfies the active conduct requirement for purposes of the definition of a QOZB under §1400Z-2(d)(3)(A)(ii).

What is the meaning of the phrase "substantially all" as used in various places in the statute?

The proposed regulations answer this question with respect to use of the phrase ''substantially all'' in §1400Z-2(d)(3)(A)(i) by providing that the threshold is 70%. However, the regulations do not address any of the other uses of this phrase throughout §1400Z-2. Treasury and the IRS have asked for comments on how to interpret that phrase in other provisions.

PART IV — CONCLUSION

It is evident from the decisions that were made in this first set of regulations that

Treasury and the IRS want to facilitate opportunity zone transactions. Although there are still a number of open issues, this is a very encouraging and much-needed set of regulations. The tax community looks forward to the second set of guidance to be released within the next couple of months.

The opportunity zone program is certainly workable within the framework of the statute and with the help of these proposed regulations. Ultimately, though, with almost every opportunity zone investment there will be one or more issues for which there is, as of yet, no ''certain'' answer. It is worth mentioning that, in spite of Treasury and IRS intent to provide guidance sufficient to foster confidence in the program, practitioners and clients will likely not get answers to every question inherent in these rules. It will be up to the analysis and creativity of tax advisors to shepherd clients through these issues, take positions that are grounded in sound analysis, and educate their clients on the identified risks. In order to do this, tax advisors should look to the original intent of the opportunity zone provisions and interpret the statutory and regulatory provisions in a manner consistent with that intent, looking to existing regulations under similar tax incentive programs as a guide, when relevant.

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In some instances, market practice may develop and essentially dictate reasonable answers to open questions. If a taxpayer takes a reasoned approach in a legitimate market-driven transaction that is not abusive and structures and operates a QOF investment in a manner that furthers the policy behind the program (facilitating economic growth and development in an opportunity zone), there should be little risk that the transaction will fail to qualify for the tax incentives based solely on a difference in the interpretation of a term or definitional test in the statute.

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