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Update on Qualified Opportunity Zones: Second Set of Guidance Issued

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OVERVIEW OF QUALIFIED OPPORTUNITY ZONE PROGRAM

The Qualified Opportunity Zone (QOZ) program, introduced in 2017's Tax Cuts and Jobs Act, is a new incentive program for investments in over 8,700 QOZs located in all 50 states, the District of Columbia, and the five U.S. possessions.

The program's benefits include gain deferral and gain elimination for taxpayers who roll over capital gain into a Qualified Opportunity Fund (QOF). Specifically, if an investor (1) recognizes capital gain from the sale of an asset to an unrelated person, (2) invests an amount equal to all or part of the capital gain in a QOF within 180 days of the date the gain is recognized (with certain exceptions for pass-through entities), and (3) makes an election (on IRS Form 8949) to treat the investment as a QOZ investment, the investor is eligible for QOZ benefits.

QOZ benefits include:

- deferral of the rolled-over gain until the earlier of when the taxpayer sells its QOF interest or December 31, 2026;
- elimination of 10% of the investor's roll-over gain if the investor holds its QOF interest for at least five years on or before December 31, 2026, and elimination of another 5% of the investor's roll-over gain if the investor holds its QOF

interest for at least seven years on or before December 31, 2026; and
- if the investor holds its interest in the QOF for at least 10 years, no gain recognized on its disposition of its QOF interest (or a QOF's disposition of certain property) provided the disposition occurs on or before December 31, 2047.

A fund, which is merely a partnership or corporation for federal income tax purposes (and not a disregarded entity), will qualify as a QOF provided that 90% or more of its assets (on average) are comprised of (1) Qualified Opportunity Zone Business Property (QOZBP) and/or (2) interests in a partnership or corporation (and not a disregarded entity) that qualifies as a Qualified Opportunity Zone Business (QOZB). QOZBP is tangible property (1) acquired after December 31, 2017, by purchase from an unrelated person; (2) (i) the original use of which in the QOZ commences with the QOF or QOZB or (ii) which the QOF or QOZB substantially improves; and (3) substantially all of the use of which is in a QOZ during substantially all the time it is held by the QOF or QOZB. The 90% test is an average of the entity's assets on two annual snapshot testing dates—the end of the entity's first six months and the last day of its taxable year (with exceptions provided for a short taxable year). Notably, cash and working capital are not "good assets" for purposes of the 90% test.

A QOZB must be a partnership or corporation for federal income tax purposes (and not a disregarded entity) that satisfies a variety of tests including:

- at least 70% of the tangible property it owns or leases is QOZBP;
- at least 50% of its gross income is from the active conduct of a trade or business in a QOZ;
- at least 40% of its intangible property is used in the active conduct of its business;
- no more than 5% of its assets are nonqualified financial property; and
- it is not a "sin business."

In contrast to a QOF, a QOZB is permitted to hold reasonable working capital. Because of the interaction between the tests that must be satisfied for an entity to qualify as a QOF or QOZB, many QOFs are likely to be organized using a two-tier structure whereby investors invest in a QOF, which in turn invests in an entity that is a QOZB.

Investors and promoters have been anxiously awaiting guidance from the U.S. Department of Treasury and the Internal Revenue Service (IRS) on the many issues raised by the statutory language creating the program. On October 19, 2018, Treasury issued the first package of proposed regulations (October 2018 Proposed Regulations) and on April 17, 2019, Treasury issued the second package of proposed regulations (April 2019 Proposed Regulations). The October 2018 Proposed Regulations provided guidance on, among other things, the types of gain that an investor may roll over, which taxpayers may roll over gain, how a fund qualifies as a QOF, how a subsidiary entity qualifies as a QOZB, the definition of QOZBP, and a safe harbor for a QOZB's working capital. But many questions remained unanswered. The April 2019 Proposed Regulations offer guidance on many, but not all, of those previously unanswered questions.

The April 2019 Proposed Regulations propose guidance on, among other things:

- what counts as a good investment in a QOF by a QOF investor;
- the ability of a QOF to sell QOZBP after 10 years;
- whether debt is included in the tax basis for a QOF investor's interest in a QOF partnership;
- whether a carried interest is eligible for QOZ benefits;
- how Code Section 1231 gain is treated;
- events that end a QOF investor's gain deferral;
- reinvestment by a QOF of proceeds from a sale of QOZBP or an interest in an entity that is a QOZB;
- what constitutes original use of tangible property for purposes of the substantial improvement requirements;
- the treatment of land as QOZBP;
- the treatment of leased property;
- the valuation of QOZBP for purposes of the QOF's 90% test and the QOZB's 70% test;
- the definition of "substantially all" where not already defined;
- property that is not in a QOZ that straddles a QOZ;
- what constitutes the active conduct of a trade or business;
- sourcing of gross income of a QOZB to a QOZ; and
- anti-abuse rules.

Taxpayers now may rely on all of these rules other than those relating to a pass-through QOF's sale of assets after a QOF investor has held its QOF interest for at least 10 years.

QOF INVESTOR GUIDANCE

An investor is eligible for QOZ benefits if, within 180 days after recognizing capital gain from the sale of property to an unrelated person, the investor invests an amount equal to all or part of that capital gain in a QOF. Surprisingly, the April 2019 Proposed Regulations provide relaxed investment requirements for a QOF investor by permitting an investor to obtain QOZ benefits if it (1) acquires an interest in a QOF from a direct owner of the QOF, not just by acquisition of the QOF interest from the QOF itself, or (2) contributes property other than cash to a QOF. If a QOF investor either contributes property to a QOF or acquires a QOF interest from a direct owner of the QOF by paying with property as opposed to cash, only the QOF investor's adjusted basis for such property is treated as a qualifying investment, and the investor's holding period for its QOF interest begins on the date it acquires the QOF interest (without tacking of the holding period before the acquisition of the QOF interest). See "Mixed Funds" below

Ballard Spahr Tip: Notwithstanding that an investor may contribute property to a QOF as a qualified investment, such property is not QOZBP (because it is not acquired by purchase by the QOF) and, as such, satisfies neither the QOF's 90% asset test nor the QOZB's 70% asset test.

Reinvesting Gains Following the Sale of a QOF Interest

The April 2019 Proposed Regulations allow a QOF investor who disposes of its entire qualifying interest in a QOF (before December 31, 2026) to timely reinvest in another QOF (and make a new deferral election) without recognizing its deferred gain. However, the holding period for the second QOF interest begins on the date the second QOF interest is acquired; there is no tacking of the investor's holding period for its original QOF interest.

QOF Investment Unwind – 10 Year Benefit – Pass-Through Entity

The Code provides that, upon a QOF investor's sale or exchange of its QOF interest, the QOF investor will not recognize gain provided that the QOF investor held its interest in the QOF for at least 10 years and the QOF investor disposes of its QOF interest on or before December 31, 2047. As a technical matter, the gain is eliminated by allowing the QOF investor to elect to step up its tax basis for its QOF interest to its fair market value immediately before the sale.

These rules raised uncertainty as to whether a QOF investor in a partnership QOF (1) would be forced to recognize ordinary income on the sale of its QOF interest (*e.g.*, from hot assets such as depreciation recapture or inventory held by the QOF or its QOZB), and (2) would be forced to recognize gain because it could not increase its tax basis for the QOF partnership interest by its share of the QOF's and QOZB's liabilities. The April 2019 Proposed Regulations provide taxpayer-friendly clarifications by providing that upon a sale of an interest in a QOF partnership that has been held for at least 10 years, the QOF investor will not recognize ordinary income and the basis step-up for the QOF partnership interest immediately before the sale is to the fair market value of the QOF interest plus the QOF investor's share of the QOF's and QOZB's liabilities.

Another issue raised by the statutory language is that the 10-year benefit is tied to the QOF investor's disposition of its QOF interest, as opposed to a QOF's or QOZB's disposition of its assets. This led to concerns that if the QOF or QOZB disposed of its assets after a QOF investor had held its QOF interest for at least 10 years, the QOF investor would be forced to recognize the gain, and created business issues that, among other things, led to the creation of many single-asset funds.

The April 2019 Proposed Regulations address some of these concerns by providing that if the QOF investor has held its qualifying investment in a pass-through QOF for at least 10 years, the pass-through QOF can dispose of its QOZBP or its interest in an entity that is a QOZB without interfering with the QOF investor's 10-year exclusion benefit. The QOF investor can make the election to exclude its allocable share of eligible gain from such a disposition reported on the Schedule K-1 of the pass-through QOF. (A similar election is available for a shareholder of a REIT QOF.)

This election applies only to a sale by a QOF of QOZBP or an interest in an entity that is a QOZB, and not to a sale by a QOF of property that is neither QOZBP nor an interest in an entity that is a QOZB. Also, this election applies only to net capital gain, not recapture (notwithstanding that if a QOF investor sells its QOF interest after holding such interest for at least 10 years, all gain, including depreciation recapture and amounts otherwise treated as ordinary income, would not be recognized). As a result, in certain cases, it may be more advantageous for an

investor to dispose of its QOF interest than it would be for the QOF to dispose of its QOZBP and/or QOZB interests.

Also, disappointingly, it appears that the 2019 Proposed Regulations do not extend this relief to a sale by a QOZB of its assets; rather, this relief is applicable only to a sale by a pass-through QOF of its assets.

Ballard Spahr Tip: Now that the QOF investor no longer is required to dispose of its interest in the QOF, some of the challenges that QOF sponsors foresaw in winding up the investment can be avoided. Given this added flexibility, we expect that more QOFs will invest in multiple assets, rather than be limited to one asset per QOF.

Partnership QOFs – Inclusion of Debt in the Tax Basis for a QOF Investor's Interest in a QOF and Debt-Financed Distributions

Typically, a partner in a partnership includes its share of the partnership's liabilities in its tax basis for its partnership interest in accordance with the rules under Code Section 752. The statutory language creating the QOZ program raises concerns as to whether the ordinary rules applicable to inclusion of partnership liabilities in a partner's basis for its partnership interest would apply to an investor's interest in a partnership QOF. The April 2019 Proposed Regulations make clear that a partner's basis for its qualifying interest in a QOF includes the partner's share of liabilities under Section 752 of the Code.

However, the April 2019 Proposed Regulations include special rules limiting the ability of a partner to receive debt-financed distributions and maintain its qualifying interest in a QOF by applying modified disguised sales rules to debt-financed distributions from a partnership QOF. In essence, it appears that a debt-financed distribution to a QOF investor within two years of the investor's qualifying contribution to the QOF will disqualify the investor's contribution from eligibility for QOZ benefits. (For our technical readers, see Prop. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(B) on page 95 of the April 2019 Proposed Regulations.) Even after two years, consideration must be given to the partnership disguised sales rules to determine if a debt-financed distribution could impact a QOF investor's QOZ benefits.

The IRS and Treasury requested comments regarding additional rules that may be necessary to limit abusive transactions designed to take advantage of differences between outside and inside basis "to create non-economic gains and losses."

Carried Interests

The April 2019 Proposed Regulations make clear that a partnership interest received for services is not eligible for QOZ benefits; this is true whether the interest is a profits interest or a capital interest acquired for services. A carried interest or capital interest acquired for services is treated as an interest in a mixed fund. See "Mixed Funds" below. The amount treated as a mixed investment is the highest share of the residual profits the carried interest holder would receive with respect

to the carried interest.

Mixed Funds

If not all of an investor's investment in a QOF is eligible for the deferral election, the investment is a a "mixed-funds" investment. A mixed-funds investment results from three situations: (1) if the QOF investor's investment in a QOF is more than the amount of the investor's eligible capital gains; (2) if the QOF investor contributes property (other than cash) to the QOF that has a fair market value that exceeds the investor's adjusted basis for such property; or (3) if the investor makes any other type of nonqualifying contribution to a QOF. Also, as noted above, a carried interest is treated as a nonqualifying investment. A QOF investor can make the deferral election only on the portion of the investment that meets the QOF requirements.

If an investor has a mixed-funds investment in a QOF, the investor is treated as having two investments, one that qualifies for QOZ benefits and the other that does not qualify. The April 2019 Proposed Regulations include rules addressing how to allocate gains and other items among the qualifying and nonqualifying investments for a QOF investor with a mixed funds investment.

Rolling Over Section 1231 Gain

Code Section 1231 applies to depreciable property and real property used in a trade or business that is held for more than one year. Net Section 1231 gain is treated as long-term capital gain (subject to a recapture rule) and net Section 1231 loss is treated as an ordinary loss. Because a taxpayer will not know if it has net Section 1231 gain until the end of a tax year, the April 2019 Proposed Regulations treat net Section 1231 gain as recognized on the last day of the tax year and start the investor's 180-day period to roll over the gain on that date. This creates a less favorable result for net Section 1231 gain than for other capital gain because, unlike other capital gains, only the net amount, not the gross amount, may be rolled over into a QOF.

Whether a partner in a partnership has net Section 1231 gain is determined at the partner level, considering the partner's Section 1231 gains and losses from all sources. The October 2018 Proposed Regulations allow a partnership to roll over capital gains it recognizes into a QOF within 180 days of when that gain is recognized. Alternatively, a partner in a partnership that recognizes capital gain may roll over that gain either within 180 days of the date the partnership recognized such gain or 180 days from the end of the partnership's tax year. The April 2019 Proposed Regulations allow a partner in a partnership that recognizes Section 1231 gain to roll over its net Section 1231 gain within 180 days of the end of the partnership's tax year. Although it is not clear, it appears that these new rules applicable to Section 1231 gains also may allow a partnership to roll over its net Section 1231 gain within 180 days of the end of its taxable year.

The IRS and Treasury requested comments on the treatment of Section 1231 gain.

Transactions Causing Deferred Gain to be Recognized – Inclusion Events

Subject to the five- and seven-year holding period gain elimination rules, deferred gain must be recognized on the earlier of the date that the QOF investor sells or exchanges its QOF interest or December 31, 2026. The April 2019 Proposed Regulations include considerable detail addressing what transactions will be "inclusion events" that would require a QOF investor to recognize its deferred gain and terminate the QOF investor's ability to obtain the 10-year benefit with respect to the interest sold or exchanged.

Generally, any transaction that reduces a QOF investor's interest in a QOF is treated as an inclusion event. Examples of inclusion events include distributions from a QOF that result in the QOF investor recognizing gain (*e.g.*, a distribution in excess of the QOF investor's adjusted basis for its QOF interest) and gifts. Helpfully, however, death is not an inclusion event; beneficiaries essentially step into the shoes of the deceased (but without a basis step-up for the deferred gain). Also, generally, a tax-free contribution of a QOF interest to a partnership is not an inclusion event.

QOF GUIDANCE

QOF 90% Asset Test – Temporary Investment Permitted for Six Months

At least 90% of a QOF's assets must be either QOZBP or interests in a QOZB, and notably cash and working capital are not "good assets" for purposes of this 90% Asset Test. In response to commentators' concerns about the rigidity of the testing dates for the 90% Asset Test (see our October 2018 e-Alert), the April 2019 Proposed Regulations provide a six-month grace period for a QOF to invest capital contributions it receives. Provided that capital contributions received by a QOF are invested by the QOF in cash, cash equivalents, or debt instruments with a term of 18 months or less, such amounts will be ignored for six months from the QOF's receipt of such capital contributions for purposes of the QOF's 90% Asset Test.

Ballard Spahr Tip: This rule alleviates the concern that a QOF may need to act quickly to spend contributed cash before a testing date to satisfy the 90% Asset Test and should greatly assist existing QOFs in managing the timing of the admission of new investors to the QOF in relation to the deployment of the funds into QOZBP or an entity that is a QOZB. For example, if a QOF receives cash as a capital contribution the first day after a testing date, since the investment would not be counted on the next six-month testing date, this grace period would allow the QOF, until the subsequent six-month testing date, to deploy the investment, which effectively results in 364 days for the QOF to deploy the funds.

QOF Reinvestment – Churning

As promised in the October 2018 Proposed Regulations, the April 2019 Proposed Regulations include the highly anticipated rules governing a QOF's reinvestment of (1) a return of capital from the QOF's investments in a QOZB, and (2) proceeds from the sale or disposition by the QOF of QOZBP. Pursuant to the April 2019 Proposed Regulations, a QOF may reinvest such amounts in QOZBP or into an entity that is a

QOZB provided that such amounts are invested within 12 months from the date of the distribution or sale/disposition, and during such 12 month-period, the proceeds are continuously held by the QOF in cash, cash equivalents, and/or debt instruments with a term of 18 months or less. To the extent this 12-month period is not met because of a delay in government action the application for which is complete, the April 2019 Proposed Regulations allow for the 12-month period to be extended. Reinvestments that satisfy these rules (1) do not reset any QOF investor's applicable investment holding period, (2) do not impact the QOF's 90% Asset Test, and (3) are not limited to reinvestments into the same type of QOZBP or into the same QOZB as the first investment.

Unfortunately, the April 2019 Proposed Regulations provide that the QOF investor must nevertheless recognize the gain on the disposition of the QOZBP or of an interest in an entity that is a QOZB if the QOF is a pass-through entity (or the QOF must recognize the gain if the QOF is a corporation). Apparently, the Treasury Department and IRS could not find precedent to allow for nonrecognition. Notably, the April 2019 Proposed Regulations request comments on examples of tax regulations that exempt the recognition of realized gain under similar authority, and whether an analogous reinvestment rule would be beneficial for an entity that is a QOZB to be able to reinvest proceeds from the disposition of QOZBP.

Ballard Spahr Tip: While the additional clarification on QOF reinvestment timeframes is helpful, the requirement that gain on the sale/disposition of assets be recognized limits the usefulness of this rule, because the resulting tax liability on interim sales/dispositions negatively impacts the QOF's return on investment. Tax liability on interim sales/dispositions also will potentially diminish the 10-year exclusion benefit since the exclusion of gain would apply only to the investment held by the QOF at the 10-year mark.

QOZBP AND LEASED PROPERTY GUIDANCE

QOZBP is property (1) purchased by a QOF or an entity that is a QOZB from an unrelated person ("related" meaning more than 20% common ownership) after December 31, 2017, (2) (i) the original use of which in the QOZ commences with the QOF or the QOZB (the "original use test") or (ii) the QOF or QOZB substantially improves such property (the "substantial improvement test"), and (3) substantially all of the use of which is in a QOZ during substantially all of the time it is held by the QOF or the QOZB.

Property is substantially improved if, during any 30-month period that such property is held by a QOF or QOZB, the QOF or QOZB spends more than its tax basis for the property at the beginning of the 30-month period. If, however, the property is land and improvements all of which are located in a QOZ that was acquired after December 31, 2017, the QOF or QOZB only must spend more than its adjusted basis for the improvements at the beginning of such 30-month period.

Original Use Test Generally

The April 2019 Proposed Regulations define "original use" by reference to when the property first is placed in service by any taxpayer for depreciation purposes. As a result, if the property was ever placed in service by any person, it has been originally used, and if the original use was in a QOZ, that property must be substantially improved. Also, improvements made to leased property satisfy the original use test and are treated as acquired by purchase. The April 2019 Proposed Regulations provide relief from the original use requirement for property (including a building or other structure) that has been vacant or unused for at least five years before purchase by a QOF or QOZB by allowing the QOF or QOZB to satisfy the original use test by placing the unused or vacant asset into service in the QOZ without requiring that such property be substantially improved.

Ballard Spahr Tip: While commentators had hoped for a shorter period of time for the vacancy exception, these clarifications of original use generally are advantageous to the taxpayer. Tying the definition of original use to whether the property has been placed in service provides clarification that a QOF or QOZB can invest in property during the construction process without having to meet the substantial improvement threshold.

Land

The April 2019 Proposed Regulations provide that if vacant land acquired or leased after December 31, 2017, is used in a trade or business, such land generally is treated as QOZBP and neither the original use test nor substantial improvement test must be satisfied with respect to such land. However, because leaving land fallow is inconsistent with the intent of the QOZ program, the April 2019 Proposed Regulations provide that vacant or minimally improved land purchased by a QOF or QOZB with no intention or expectation that the land will be materially improved does *not* constitute QOZBP. Also, Treasury and the IRS requested comments on whether additional rules are necessary to prohibit land banking.

Ballard Spahr Tip: Land acquired or leased before January 1, 2018, is not eligible for the special rule that permits land not to be substantially improved, and is not a good asset for the QOF 90% asset test or the QOZB 70% asset test.

Substantial Improvement Test – Multiple Assets

In one of the few provisions likely to be considered unfriendly to taxpayers, the April 2019 Proposed Regulations make clear that the substantial improvement test must be applied on an asset-by-asset basis. For example, if a QOF or QOZB acquires two buildings (neither of which was vacant for five years) within a QOZ and substantially improves only one of the two, only the building that has been substantially improved would be QOZBP. Notwithstanding this conclusion, the IRS and Treasury noted that this requirement may be onerous for certain types of businesses and requested

comments as to whether future guidance should apply an aggregate standard for determining compliance with the substantial improvement test, whether property not capable of being substantially improved should be exempted from the substantial improvement rule, and whether the purchase of non-original use property together with items of original use property should be aggregated to determine whether the test is satisfied.

Ballard Spahr Tip: That the substantial improvement test must be applied on an asset-by-asset basis is particularly troubling for an operating business. For example, if a QOZB acquires all of the assets of a software business located in a QOZ, technically the QOZB would be required to substantially improve each desk, chair, computer, etc., for such property to qualify as QOZB. The asset-by-asset approach will likely be a roadbloack for existing businesses in a QOZ planning to expand the business when they must satisfy the QOZB 70% asset test.

Leased Property

The April 2019 Proposed Regulations include taxpayer-friendly rules for property leased by a QOF or QOZB. Leased property will qualify as QOZBP if (1) the property is leased pursuant to a lease entered into after December 31, 2017, (2) at the time the lease is entered into, the lease terms are arms-length, (3) during at least 90% of the QOF's or QOZB's (as the case may be) holding period for such leased property, 70% of the leased property's use is in a QOZ, and (4) if the lease is with a related party (20% common ownership), (i) the lessee cannot make any prepayments of rent for a period exceeding 12 months, (ii) if the leased property is tangible *personal* property and the original use of such property in a QOZ did not commence with the lessee, the lessee must become the owner of tangible property in an amount at least equal to the value of the property leased from a related person within the earlier of (a) 30 months after the lessee receives possession of the leased property or (b) the end of the lease term, and (iii) there must be substantial overlap in the QOZs where the leased property and the property acquired in (ii) is used. However, if there is a plan, intention, or expectation that leased real property is to be acquired by the QOF or QOZB for other than the fair market value of such land, the property never will be QOZBP.

As is true of land acquired after December 31, 2017, land leased after December 31, 2017, is not required to be substantially improved. The IRS and Treasury requested comments on all aspects of the leased property rules.

Valuation

As described in the October 2018 Proposed Regulations, there are two valuation methods for the QOF 90% asset test and the QOZB 70% asset test. The first is the applicable financial statement valuation method—valuation of tangible property is based on the book value (after depreciation and amortization) reported on an applicable financial statement—and the second is the alternative valuation method —valuation of tangible property is based on the original cost basis for the property.

The April 2019 Proposed Regulations allow a QOF or QOZB to choose which method to use annually and there is no consistency requirement year-to-year.

Special valuation rules are provided in the April 2019 Proposed Regulations for leased property. One valuation method is the applicable financial statement valuation method. The applicable financial statement method may be used only if the financial statement is prepared in accordance with GAAP and GAAP assigns a value to the leased property. Alternatively, the leased property may be valued by calculating the present value of the lease payments using the applicable federal rate as the discount rate. If the lease is valued on the present value method, the value is determined when the lease is entered into and used for all testing dates.

"Substantially All"

The October 2018 Proposed Regulations and the April 2019 Proposed Regulations provide safe harbors for what constitutes "substantially all" where that term is used in the provisions governing QOZ benefits: (1) substantially all of a QOZB's tangible property owned or leased must be QOZBP (at least 70%); (2) tangible property is QOZBP if, among other things, during substantially all of the QOF's or QOZB's (as the case may be) holding period for such property (at least 90%), substantially all of the use of such property is in a QOZ (at least 70%); and (3) for substantially all of the time a QOF owns an interest in a subsidiary (at least 90%), the subsidiary must be a QOZB.

QOZB GUIDANCE

The April 2019 Proposed Regulations address several of the issues raised in comments on the language in the Code and the October 2018 Proposed Regulations about what qualifies as a QOZB. To qualify as a QOZB, an entity must be a subsidiary of a QOF that is a partnership or corporation for federal income tax purposes and: (1) at least 70% of the tangible property the entity owns or leases is QOZBP; (2) at least 50% of the entity's gross income is from the active conduct of a trade or business in a QOZ; (3) at least 40% of the entity's intangible property is used in the active conduct of its business; (4) no more than 5% of the entity's assets are nonqualified financial property; and (5) the entity does not conduct a sin business. While the guidance in the April 2019 Proposed Regulations is helpful, unfortunately, many aspects, particularly those relating to operating businesses as opposed to real estate investments, are left to future guidance.

Property Straddling a QOZ

An entity that holds real property straddling multiple census tracts, not all of which are designated as QOZs, still may qualify as a QOZB. For purposes of determining whether at least 50% of the entity's gross income is from the active conduct of a trade or business in a QOZ or whether tangible property is located in a QOZ, real property is deemed to be located within a QOZ if the QOZB's real property located within the QOZ is "substantial" as compared to the amount of the QOZB's real property located outside of the QOZ. The April 2019 Proposed Regulations provide that real property located within the QOZ is considered substantial if (1) the square footage of the property located within a QOZ is substantial as compared to the

square footage of the real property located outside of the QOZ and (2) the real property located outside of the QOZ is contiguous to all or part of the real property located in the QOZ. However, the preamble to the April 2019 Proposed Regulations provides that real property located within a QOZ should be considered substantial if the unadjusted cost of the real property inside the QOZ is greater than the unadjusted cost of the real property outside the QOZ. Presumably, the IRS and Treasury will reconcile these different tests. In addition, it is unclear whether real property located across the street from real property in a QOZ is contiguous to the real property in the QOZ.

Active Conduct of a Trade or Business

Consistent with Proposed Regulations addressing other provisions of the Tax Cuts and Jobs Act, the April 2019 Proposed Regulation provide little guidance as to what constitutes the "active conduct of a trade or business" for purposes of the requirement that at least 50% of the total gross income of a QOZB be derived from the active conduct of a trade or business within a QOZ. Instead, the April 2019 Proposed Regulations refer to the general rules under Section 162(a) of the Code, but notably allow for special rules for rental real estate.

The April 2019 Proposed Regulations provide that the ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business for purposes of the QOZB provisions. However, the April 2019 Proposed Regulations also provide that merely entering into a triple net lease is not the active conduct of a trade or business.

Ballard Spahr Tip: The special rules for real estate eliminate most of the uncertainty surrounding whether rental real estate is an active trade or business. Moreover, it seems that even triple net leased real estate could qualify as an active trade or business if services are provided by the landlord/owner.

The IRS and Treasury requested comments on, among other things, the proposed definition of trade or business, whether a trade or business is actively conducted, as well as whether the active trade or business requirement also should apply to QOFs.

Sourcing Gross Income to a QOZ

The April 2019 Proposed Regulations provide much-needed guidance on the sourcing of gross receipts to a QOZ. There are three proposed safe harbors to calculate whether at least 50% of a business's gross income is sourced to a QOZ:

- Hours Test - if at least 50% of the services are performed in the QOZ, determined by comparing the hours of work performed for the business by its employees and independent contractors (and employees of independent contractors) within the QOZ to the total hours of work performed for such business by its employees and independent contractors (and employees of independent contractors);

- Pay Test - if at least 50% of the services are performed in the QOZ, determined by comparing the amounts paid by a business to its employees and independent contractors (and employees of independent contractors) for services performed in the QOZ to the total amount paid by the business for employee and independent contractor (and employees of independent contractors) services performed during the taxable year; or
- Qualitative Test - a qualitative determination that the tangible property of the business that is in a QOZ and the management or operational functions performed for the business in the QOZ are each necessary to generate at least 50% of the gross income of the trade or business.

The inclusion of independent contractors and the employees of independent contractors may complicate the analysis for the first two safe harbors. In addition, a business could apply a facts-and-circumstances analysis if it failed to meet any of the three safe harbors. The IRS and Treasury have requested comments on additional safe harbors and modifications to those listed above.

Ballard Spahr Tip: These safe harbors should allow substantial flexibility for QOZBs that plan accordingly. The location of the QOZB's customers is largely irrelevant, so a QOZB can locate its activities in the QOZ even if its customer base is not within the QOZ.

Intangible Property

With respect to the use of intangibles by a business, the April 2019 Proposed Regulations provide that at least 40% of the intangible property of a QOZB must be used in the active conduct of a trade or business in the QOZ. No safe harbor method of measuring the percentage is provided.

Working Capital Safe Harbor

Pursuant to the Code, a QOZB may hold reasonable working capital. The October 2018 Proposed Regulations provide a safe harbor for what constitutes reasonable working capital: (1) the working capital is designated for the acquisition, construction and/or improvement of tangible property in a QOZ; (2) there is a written schedule consistent with the ordinary startup of a trade or business for the expenditure of the working capital; (3) the working capital is spent within 31 months of the receipt of the funds; and (4) the working capital is used substantially consistent with the foregoing.

In response to comments on the October 2018 Proposed Regulations, the April 2019 Proposed Regulations also permit an operating business to take advantage of the 31-month safe harbor. This expansion of the safe harbor puts operating businesses on parity with tangible property investments. The April 2019 Proposed Regulations also provide that a business will not fail to meet the working capital safe harbor if the 31-month period is exceeded if the delay is attributable to waiting for government action the application for which is completed during the 31-month

period. This governmental delay exception applies to both tangible property owned by a QOZB and an investment by a QOF in a QOZB.

The April 2019 Proposed Regulations also clarify that a QOZB may have multiple sequential 31-month working capital safe harbor periods; a new 31-month safe harbor period begins each time the QOZB receives funds.

CONSOLIDATED RETURN RULES GUIDANCE

The April 2019 Proposed Regulations provide special rules for consolidated groups, including clarifying that the member that recognizes capital gain must be the member that rolls over the gain to a QOF, and providing that stock of a corporation that is a QOF is not treated as stock for purposes of determining whether the corporation is a member of the consolidated group. Thus, although a corporate QOF can be the parent of a consolidated return group, a corporate QOF cannot otherwise be a member of a consolidated return group.

GENERAL ANTI-ABUSE RULE GUIDANCE

The April 2019 Proposed Regulations include a broad, generally applicable, anti-abuse rule that allows the IRS to recast a transaction or series of transactions as necessary to achieve the goals of the QOZ rules. Whether a transaction is inconsistent with the QOZ rules will be based on all relevant facts and circumstances. The preamble to the April 2019 Proposed Regulations illustrates that the anti-abuse rule could be used by the IRS to re-characterize agricultural land that otherwise would be treated as QOZBP as other than QOZBP if the taxpayer did not plan to make a material investment in the land and if a significant purpose of purchasing the land was to "achieve an inappropriate tax result."

UNRESOLVED ISSUES AND QUESTIONS NOT YET ANSWERED

- Will any facts and circumstances allow an investor in a QOF partnership to treat debt-financed distributions received from a QOF partnership within two years after the investor's contribution to the QOF partnership as other than a disguised sale and therefore not disqualify the investor's contribution from QOZ benefits?
- Can a QOZB, as opposed to a QOF, reinvest proceeds from the disposition of QOZBP?
- Will Treasury/IRS find the authority to provide for the nonrecognition of gain in the context of QOF reinvestments/churning?
- What is reasonable cause if the 90% Asset Test is failed?
- How will the substantial improvement requirements apply in the context of the acquisition of the assets of an operating business by a QOZB?
- What additional information will the IRS require from a QOF concerning its investments?

This post features contributions from Christopher A. Jones.

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