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Round two: IRS issues a second set of corrective amendments to the qualified opportunity fund regulations

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Introduction

On August 5, 2021, the Treasury Department ("Treasury") and Internal Revenue Service ("IRS") issued a second set of corrective amendments (the "2021 Corrective Amendments")[1] to the final qualified opportunity zone ("QOZ") regulations under section[2] 1400Z-2 (the "Final Regulations").[3] The 2021 Corrective Amendments are effective on August 5, 2021, and applicable on or after January 13, 2020, the date the Final Regulations were originally issued. This article focuses on the correction for which the QOZ industry has long awaited – clarification of a special rule for start-up businesses utilizing the working capital safe harbor.[4]

To put the 2021 Corrective Amendments into perspective, consider the following example:

> Developer owns a parcel of land on which it would like to develop and operate a residential rental project. The land is located in a QOZ. Investor intends to invest cash from a recent capital gains event into the developer's project and obtain tax benefits under the QOZ program. Developer and investor would like to form a partnership to which the developer contributes the land and the investor, through a qualified opportunity fund ("QOF"), contributes cash for use in the development of the land.
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> Although this fact pattern appears to involve the type of long-term investment in a QOZ that the QOZ program intended to encourage, as described below, the Final Regulations were unclear as to whether the partnership between the developer and the investor's QOF could satisfy the QOZ program's requirements. The 2021 Corrective Amendment provide the necessary clarity for this transaction.

Background on qualified opportunity funds

As part of the Tax Cut and Jobs Act,[5] Congress enacted section 1400Z to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing U.S. federal income tax benefits to taxpayers who invest in businesses located within these zones.[6] Specifically, an investor who is an eligible taxpayer[7] and who has eligible gains[8] can invest a dollar amount equal to those gains into a qualified opportunity fund ("QOF")[9] and receive the following U.S.

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[1] See **2021-16663.pdf (federalregister.gov)** for full text.
[2] Unless otherwise indicated, all references to the term "section" refer to the Internal Revenue Code of 1986, as amended or the applicable regulations thereunder.
[3] T.D. 9889, 85 FR 1866 (January 13, 2020). The Final Regulations had previously been corrected on April 1, 2020 (the "2020 Corrective Amendments"). See 2020-07013.pdf (federal register.gov). For additional insights on the Final Regulations, see KPMG, The road has been paved—Analysis and observations about final regulations and future of opportunity zone investments, https://home.kpmg/us/en/home/insights/2020/01/tnf-kpmg-report-analysis-and-observations-about-final-regulations-and-future-of-opportunity-zone-investments.html.
[4] In addition to the correction discussed in this article, the 2021 Corrective Amendments also update the self-decertification rules for a qualified opportunity fund.
[5] Pub. Law No. 115-97.
[6] Preamble to proposed regulations, 83 FR 54279, REG-115420-18, (October 29, 2018).
[7] Section 1.1400Z2(a)-1(b)(13).
[8] Section 1.1400Z2(a)-1(b)(11).
[9] Section 1400Z-2(d)(1).

federal income tax benefits: (1) immediate deferral of the gain until December 31, 2026;[10] (2) the potential elimination of up to 15% of that original gain depending on when the investment is made;[11] and (3) elimination of gain on any appreciation in the investment if the investment is held for at least 10 years.[12]

To be a QOF, at least 90% of the entity's assets must be QOZ property, determined on a semiannual basis, based on the cumulative amount of time the QOF has held the property.[13] As most relevant to the 2021 Corrective Amendments, QOZ property includes certain equity interests in a domestic corporation or partnership if the corporation or partnership is a qualified opportunity zone business ("QOZB").[14] To be a QOZB, the corporation or partnership must be engaged in a section 162 trade or business[15] -

1. In which 70% of the tangible property owned or leased by the taxpayer is QOZ business property (the "70% tangible property requirement");[16]

2. Which satisfies the requirements of paragraphs (2), (4) and (8) of section 1397C(b) (the "1397C(b) requirements"); and

3. Which is not described in section 144(c)(6)(B).[17]

An entity's qualification as a QOZB is generally determined at the end of it taxable year and its status applies for the entire taxable year.[18]

To be QOZ business property,[19] tangible property must, among other things, be used in the entity's trade or business and the entity must have acquired the property by purchase after December 31, 2017.[20] For this purpose, a "purchase" generally means any acquisition of property, but only if the property is not acquired from a related party[21] or member of the same controlled group[22] and the basis of the property in

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[10] Section 1400Z-(a)(1). If the taxpayer sells or exchanges the investment prior to December 31, 2026, the deferred gain is included in the taxable year of the sale or exchange. Section 1400Z-2(b)(1); section 1.1400Z2(b)-1.
[11] Section 1400Z-2(b)(2)(B).
[12] Section 1400Z-2(c).
[13] Section 1400Z-2(d)(1)-(2).
[14] For the other requirements for equity interests in a corporation or partnership to be QOZ property, see section 1400Z-2(d)(2)(B) and (C), respectively.
[15] Section 1.1400Z2(d)-1(d)(1).
[16] Section 1400Z-2(d)(3)(A)(i) requires that "substantially all" of the entity's tangible property be QOZ business property. The Final Regulations defined "substantially all" for this purpose as 70%. Section 1.1400Z2(a)-1(b)(2); section 1.1400Z2(d)-1(d)(1), (2). Whether a trade or business satisfies the 70% tangible property standard is determined by a fraction – (1) the numerator of which is the total value of all tangible property owned or leased by the QOZB that is QOZ business property; and (2) the denominator of which is the total value of all tangible property owned or leased by the QOZB, whether located inside or outside of a QOZ. Section 1.1400Z2(d)-1(d)(2)(ii).
[17] Section 144(c)(6)(B) provides a list of certain trades or business (*i.e.*, any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises).
[18] Section 1.1400Z2(d)-1(d)(1).
[19] See, section 1400Z-2(d)(2)(D) and (d)(3)(A)(i).
[20] Section 1400Z-2(d)(2)(D)(i)(I). In addition to the acquisition requirement, the property must be either original use property or the property must be substantially improved. Section 1400Z-2(d)(2)(D)(i)(II); section 1.1400Z2(d)-2(b)(3); (4). During substantially all of the QOZB's holding period for the property, substantially all of the use of the property must be in the QOZ. Section 1400Z-2(d)(2)(D)(i)(III). For this purpose, substantially all of the QOZB's holding period is defined as 90%. Section 1.1400Z2(d)-2(d)(3). Substantially all of the use of the property is based on 70% of the total utilization of the property by the trade or business in a QOZ. Section 1.1400Z2(d)-2(d)(4).
[21] Section 179(d)(2)(A). For this purpose, relatedness is determined under section 267(b) or section 707(b)(1) (but, in applying section 267(b) and (c), section 267(c)(4) is treated as providing that the family of an individual includes only his spouse, ancestors, and lineal descendants). Section 179(d)(2)(A). In addition, for purposes of applying section 267(b) and section 707(b)(1) to a QOF or QOZB, "20%" is substituted for "50%" each place it occurs. Section 1400Z-2(e)(2).

the hands of the acquiror is not determined, in whole or in part, by reference to the adjusted basis of such property in the hands of the person from whom acquired (*i.e.,* carry-over basis transactions) or under section 1014(a) (relating to property acquired from a decedent).[23]

To be a QOZB, the partnership or corporation must also satisfy the section 1397C(b) requirements, including that less than 5% of the average of the aggregate unadjusted bases of the property of the QOZB may be attributable to **nonqualified financial property**.[24] To assist an entity in satisfying this nonqualified financial property rule, the Final Regulations included a safe harbor under which cash is considered reasonable in amount and therefore excluded from the definition of nonqualified financial property, provided certain requirements are satisfied (the "working capital safe harbor").[25]

The Final Regulations also included safe harbors for the classification of tangible property as QOZ business property when the property is subject to development as part of the working capital safe harbor period. For example, the Final Regulations provided that if 1) an entity has nonqualified financial property that is treated as reasonable working capital under a working capital safe harbor plan and 2) the tangible property subject to the working capital safe harbor plan is expected to be QOZ business property as a result of the planned expenditure of working capital described in the working capital safe harbor plan, then the tangible property purchased, leased, or improved by the trade or business, pursuant to the written working capital safe harbor plan is treated as QOZ business property during that and subsequent working capital periods the property is subject to, for purposes of the 70% tangible property requirement in section 1400Z-2(d)(3).[26]

Thinking back to our example, the partnership between the developer and the investor's QOF must be a QOZB in order for the investor to obtain tax benefits under the QOZ program. However, as contemplated above, immediately after formation, the land contributed by the developer will be the only tangible property held by the partnership. Because the land is contributed to the QOZB it is not "acquired by purchase" within the meaning of the QOZ rules. Accordingly, prior to the 2021 Corrective Amendments it appeared that such an entity (or an entity acquiring property from a related party, or other nonqualifying QOZ business property from its date of formation) might not satisfy the QOZB requirements both as of its initial testing date and going forward due to the cumulative nature of the QOZB tests.[27] Even though the working capital safe harbors would allow the partnership to hold the contributed cash as reasonable working capital, the Final Regulations, as originally issued, did not include a safe harbor for an entity holding predominantly nonqualifying tangible property upon formation.

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[22] Section 179(d)(2)(B).
[23] Section 179(d)(2)(C).
[24] Section 1397C(b)(8) and section 1.1400Z2(d)-1(d)(3)(iv).
[25] Section 1.1400Z2(d)-1(d)(3)(v). Under the working capital safe harbor, cash equivalents and debt instruments with a term of 18 months or less may also be excluded from the definition of nonqualified financial property as reasonable working capital. Section 1397C(e) and section 1.1400Z2(d)-1(d)(3)(v).
[26] Section 1.1400Z2(d)-1(d)(3)(viii). See also, section 1.1400Z2(d)-1(d)(3)(vi)(D)(2), as updated by the 2020 Corrective Amendments.
[27] At some point, the cash contributed may have been used to construct tangible property such that 70% of the tangible property of the partnership in a future year would be QOZ business property. The entity, however, could still have difficulty meeting the holding period requirement described in footnote 20, *supra* because of the cumulative nature of the holding period test and the initial periods of time during which the partnership did not satisfy the 70% tangible property requirement.

The 2020 corrective amendments

Within a few months of publishing the Final Regulations, the Treasury and IRS released the first set of corrective amendments. As relevant to the 2021 Corrective Amendments, the 2020 Corrective Amendments included additional safe harbors designed to assist an entity in satisfying the requirements to be a QOZB, including the 70% tangible property requirement and the 1397C(b) requirements.

The 2020 Corrective Amendments included the following additional safe harbor for working capital:

> "If [the working capital safe harbor] treats property of an entity that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of section 1.1400Z2(d)-1(d)(3)(v)(A) through (C) of this section, *the entity satisfies the requirements of section 1400Z-2(d)(2)(D)(i)* only during the working capital safe harbor periods for which the requirements of section 1.1400Z2(d)-1(d)(3)(v)(A) through (C) are satisfied; however, such property is not QOZ business property *for any purpose* (emphasis added) (the "(D)(1) safe harbor").[28]

Note the reference to section 1400Z-2(d)(2)(D)(i) is the general definition of QOZ business property. It is this provision that is at the heart of the 2021 Corrective Amendments.

Consider again the example above. The partnership holds land and cash that was contributed for the purpose of developing the land. Assume that the partnership properly complies with the working capital safe harbor with respect to the cash and the development project. In other words, the working capital safe harbor treats property of the partnership that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of section 1.1400Z2(d)-1(d)(3)(v)(A) through (C).

The final clause of the (D)(1) safe harbor, as originally provided for in the 2020 Corrective Amendments, specifically stated that the working capital assets of the partnership that are considered reasonable under the working capital safe harbor (*i.e.,* "such property") would not be considered QOZ business property *for any purpose*. However, the (D)(1) safe harbor also provided that the partnership satisfies the requirements of section 1400Z-2(d)(2)(D)(i) (*i.e.,* the definition of QOZ business property) during the working capital safe harbor period. Although it was apparent to many tax practitioners that the IRS intended to say that the entity satisfied the 70% tangible property requirement, the cross-reference to the definition of QOZ business property introduced some uncertainty because it was unclear what it meant for the partnership to satisfy the definition of QOZ business property (*i.e.,* because the requirements of section 1400Z-2(d)(2)(D)(i) determine whether tangible property qualifies as QOZ business property, the requirements are not directly applicable to an entity).

[28] Section 1.1400Z2(d)-1(d)(3)(vi)(D)(*1*), as updated by the 2020 Corrective Amendments. Although not specifically provided for in the language, we understand that Treasury and the IRS intended for this safe harbor to be available only to start-up businesses.

The 2021 corrective amendments

The 2021 Corrective Amendments resolved any ambiguity in the application of the (D)(1) safe harbor. As revised by the 2021 Corrective Amendments, section 1.1400Z2(d)-1(d)(3)(vi)(D)(*1*) now reads as follows (changes shown in italics):

> "*For start-up businesses utilizing the working capital safe harbor,* if [the working capital safe harbor] treats property of an entity that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of section 1.1400Z2(d)-1(d)(3)(v)(A) through (C), the entity satisfies the requirements *of section 1400Z-2(d)(3)(A)(i)* only during the working capital safe harbor periods for which the requirements of section 1.1400Z2(d)-1(d)(3)(v)(A) through (C) are satisfied; however, such property is not QOZ business property for any purpose.

The revised (D)(1) safe harbor eliminates the cross-reference to the definition of QOZ business property. As revised, the (D)(1) safe harbor now specifically refers to the satisfaction of the 70% tangible property requirement in section 1400Z-2(d)(3)(A)(i). Accordingly, under the 2021 Corrective Amendments, it is clear that an entity that qualifies for the (D)(1) safe harbor is deemed to satisfy the 70% tangible property requirement while subject to the working capital safe harbor.

The 2021 Corrective Amendments also specifically limit the availability of the (D)(1) safe harbor to start-up businesses. Accordingly, a newly formed entity that has not yet begun its trade or business (*e.g.*, like the partnership in our example) may qualify for this additional safe harbor to give it time to "grow" out of the bad tangible property that was contributed for development.[29] Thus, as a practical matter, a start-up QOZB can develop property on "bad" land during its working capital safe harbor period. So long as the QOZB satisfies the 70% tangible property requirement, taking into account the developed property and the land, by the expiration of the relevant working capital safe harbor period, the QOZB continues to satisfy its 70% tangible property requirement.

For entities that are not start-up businesses, this additional time period to cover nonqualifying tangible property is not available. Instead, those entities that are already engaged in a trade or business generally must satisfy the 70% tangible property requirement from the time they intend to qualify as a QOZB. However, these entities may be able to use the other safe harbors applicable to property under construction for which working capital is being expended to qualify certain property as QOZ business property during their working capital safe harbor periods even though the property is not yet being used in the trade or business.[30]

Although now specifically limited to start-up businesses, the additional correction to the language discussed above in the 2021 Corrective Amendments is a welcomed confirmation of the position taken by many QOZBs and their advisors that the (D)(1) safe harbor allows a QOZB flexibility in satisfying the 70% tangible property requirement when it enters its startup period with some nonqualifying tangible property.

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[29] The (D)(1) safe harbor applies to other non-qualifying tangible property, for example, land that is purchased from a related party.
[30] See footnote 26*, supra,* and accompanying discussion.

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