Excerpted from the book *H\Y@Y[U; i]XYlc 5 ZZfXUVY< ci g]b[8 YjYcda Ybh,* Third Edition (Chapter +)" ©202& by the American Bar Association. Reprinted with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

7

Using the Qualified Opportunity Zone Incentive with Affordable Housing

Glenn A. Graff, Megan Murphy, and John Sciarretti

I. INTRODUCTION

The Tax Cuts and Jobs Act of 2017 introduced the opportunity zone (OZ) regime, a tax incentive designed to encourage long-term investment in low-income areas to spur economic growth and job creation.[1] The incentives are threefold and are designed to increase in value the longer an opportunity zone investment is held. We discuss the benefits further *infra*. At a very high level, by timely investing eligible gains in a fund that has a purpose of investing in OZs (a "qualified opportunity fund," or QOF), an eligible taxpayer can defer taxation of the gains until 2026, exclude as much as 15 percent of these gains from taxation, and the taxpayer's investment in the fund can grow tax free if held for at least ten years. The requirements to qualify for these benefits, including what constitutes a "timely" investment, "eligible gains," an "eligible taxpayer," and a "QOF," are discussed in the pages that follow.

While these tax benefits are valuable, they are designed to be complementary to an investor's economic return on investment along with other federal and state tax incentives, particularly tax credit incentives. For example, OZ investing can be paired with projects that are eligible for the low-income housing tax credit, the historic tax credit, or, less commonly, the new markets tax credit. Such real estate OZ projects will generally take a legal structure in which a partnership QOF invests in an operating partnership that will own

1. The OZ provisions are contained in Internal Revenue Code Sections 1400Z-1 (Designation of Qualified Opportunity Zones) and 1400Z-2 (Special Rule for Capital Gains Invested in Opportunity Zones). The Internal Revenue Service (IRS) has issued lengthy regulations implementing Section 1400Z-2 and such regulations are located at Treasury Regulation Sections 1.1400Z2-0 through 1.1400Z2-(f).

len50412_complete.indb 221 1/13/22 8:40 AM

and operate the real estate. That lower-level partnership will need to meet the requirements to be a Qualified Opportunity Zone Business (QOZB). See Figure 7.1; statutory and regulatory requirements of QOZBs discussed *infra*. Fortunately, as we will discuss, the QOZB requirements are generally compatible with developing affordable housing.

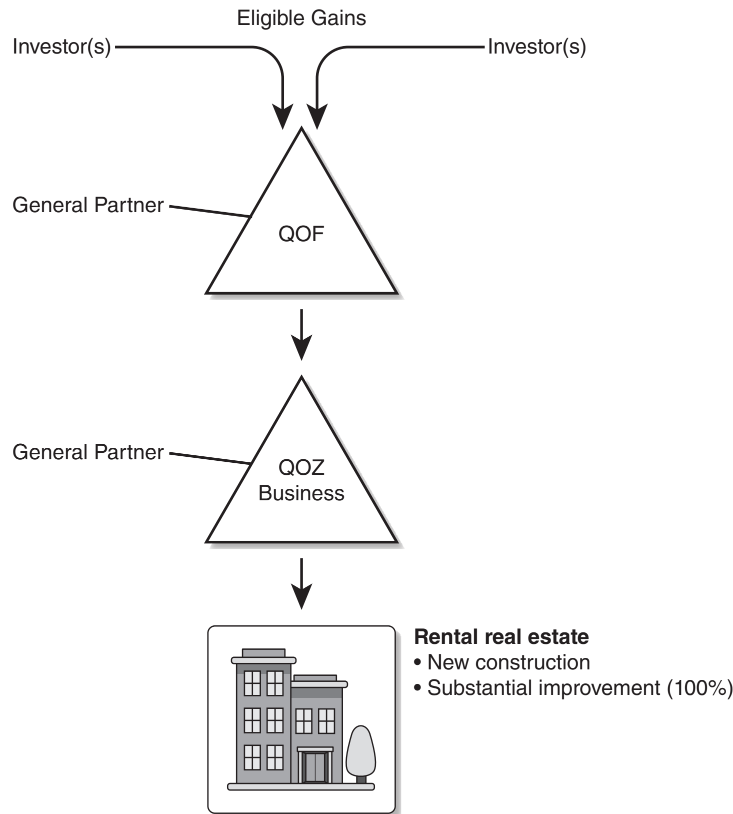

Figure 7.1

The Internal Revenue Code sections that constitute the opportunity zones statute are about 2,250 words long. The final Treasury regulations, finalized in December 2019, are over 60,000 words long, with further Treasury commentary in the preamble to the final regulations and additional correcting regulation amendments issued as recently as August 2021. The incentive took considerable time and effort to implement and continues to develop today, including proposed legislation around QOF reporting and deferral of the 2026 gain recognition date to 2029. Even so, with many of the early uncertainties resolved and with businesses looking toward post-COVID plans, opportunity zone investment appears to be increasing in 2021.

This chapter first provides a brief overview of how the OZ incentive can be used with affordable housing. The second part of the chapter discusses the very detailed rules involved in using the OZ incentive. As used in this chapter, “Code” or “I.R.C. §” refers to

the Internal Revenue Code of 1986, as amended. "Treas. Reg." and "Regulations" mean the Income Tax Regulations issued under the Code and preceding federal tax laws; and "IRS" or "Service" means the Internal Revenue Service.

II. OVERVIEW OF USING THE OZ INCENTIVE TO PROMOTE AFFORDABLE HOUSING

The OZ incentive can be leveraged to create affordable housing in a number of ways. OZs can be used with the Low-Income Housing Tax Credit (LIHTC) under Code Section 42, with historic rehabilitation tax credits (HTC) under Code Section 47, and sometimes with New Markets Tax Credits (NMTC) under Code Section 45D. It is also possible for OZ equity to be a separate layer of financing for projects with or without tax credits, or even for the developer/sponsor of affordable housing to provide OZ equity. The use of OZ equity for workforce housing has also been shown to be popular.

A. Structures for Investors to Receive Both LIHTC and OZ Benefits

Structurally, OZs can be used with LIHTC. The benefit from coupling OZs with LIHTC is very dependent on the structure involved and can range from a modest benefit to a more significant benefit. However, the benefit from LIHTCs in most cases will significantly outweigh the OZ benefit with the OZ incentive providing incremental value.

The structure of using OZs with LIHTC is not much different from the typical LIHTC structure. In a typical LIHTC structure, a tax credit investor invests in a syndication fund. That fund then invests in one or more partnerships that will own and operate low-income housing. This tiered partnership structure provides tax credit investors with LIHTCs and flow-through of depreciation expenses. Because affordable housing is real estate- and fixed asset-heavy, the businesses and projects incur large depreciation expenses.

The OZ structure is the same. Under the OZ incentive, an eligible taxpayer (defined *infra*) with eligible gains invests in a QOF (which is a fund), and that QOF invests in a partnership that will qualify as a QOZB. It is important to note that the OZ rules do not allow for additional layers of ownership. The taxpayer has to invest directly in the fund and the fund has to invest in a partnership that owns and operates the real estate.[2] Fund management will be very similar, with the exception that a QOF manager needs to ensure that it invests at least 90 percent of its assets in qualifying partnerships, and provide oversight and assistance to the QOZB partnerships so that they will initially meet the QOZB requirements and continue to meet those requirements for the duration of the investment.

In order to receive depreciation deductions and tax credits and to have a valid OZ investment, the investment needs to be respected as equity, rather than debt. Preferred interests are permitted, as are partnership interests with special allocations,[3] but features such as a set return known in advance are problematic.

---

2. Technically the QOF can invest in a corporation, but that is unlikely to be a useful structure for investments in affordable housing. Real estate investments generally benefit from the tax flow-through ability allowed by partnerships.

3. Treas. Reg. § 1.1400Z2(a)-1(b)(12)(i).

1. How OZ Requirements Relate to LIHTC Projects

As shown by the hundreds of pages of regulations, the OZ requirements are quite complex. Fortunately, they are generally compatible with LIHTC projects.

Location. The most basic OZ requirement is that the investment must be in a Qualified Opportunity Zone (a QOZ). QOZs, defined in more detail *infra*, are designated low-income communities. Many LIHTC projects are located in low-income census tracts, so it is possible for a LIHTC project to be in a QOZ. However, because states were limited to nominating 25 percent of their low-income census tracts and certain adjacent tracts, it is critical in planning to pair the OZ incentive with LIHTCs to ensure that a proposed LIHTC project is in fact in a QOZ.

Related Party Restrictions. OZs have related party restrictions, which generally complicate a QOZB's acquisition of property where the seller of property has more than a 20 percent interest in the QOZB partnership. LIHTC projects have a very similar restriction, but the related party threshold is 50 percent. While the OZ related party rules are more restrictive, these rules can be managed in similar ways as LIHTC projects with their 50 percent restriction. Features such as seller financing, deferred developer fees, loans from related parties, and a nonprofit right of first refusal under Section 42 may mitigate the impact of the related party rules by allowing economics to be paid out to related parties in the form of legitimate fees and debt repayment or a right of first refusal rather than distributions to partners.

50 Percent Gross Income from QOZ. QOZBs need to have 50 percent of their income come from the active conduct of a trade or business within the QOZ. As a real estate–based business, meeting such requirements should not be difficult for a LIHTC project located in a QOZ.

Timeline. Another similarity between LIHTC and OZ investing is the timeline involved. LIHTC investments are commonly held for at least 15 years, although sometimes investors may exit after ten years of operations. For OZ investments, the timeline is generally at least ten years of investment, with such time including the construction period. As a result, the OZ timeline is less restrictive than the typical LIHTC investment window.

QOF Must Acquire QOZB Partnership Interest as Original Issue—Syndicator Structuring. In LIHTC transactions, it is common for a syndicator to purchase a LIHTC partnership interest in its own name and then transfer that interest to a LIHTC syndication fund at a later date when investors for the fund have been secured. However, such a structure would not work for an OZ investment. In order for the syndication fund to qualify as a QOF, the QOF will likely need the LIHTC partnership interest to qualify as qualified opportunity zone property (QOZP). One of the requirements of Code Section 1400Z-2(d)(2)(C)(i) for a QOZB partnership interest to be QOZP is that such partnership interest has to be acquired directly from the partnership in exchange for cash. As a result, acquisition of the partnership interest by the syndicator and followed by a transfer to a fund would not qualify. Therefore LIHTC-OZ syndicators need to arrange for a "direct closing" in which the syndicator's QOF directly invests cash in the LIHTC partnership in exchange for the partnership interest.

2. Benefits of Pairing OZ and LIHTC

The benefits of pairing OZ with LIHTC can vary from light to significant. For QOF investments that have been held for seven or five years as of December 31, 2026, that is,

investments made by the end of 2019 or 2021, 15 percent or 10 percent of the deferred capital gains tax that would be due can be avoided. In addition, there are the following benefits.

Tax-Free Appreciation. After meeting a ten-year OZ holding period, QOFs that invest in LIHTC projects that are QOZBs can benefit from the OZ incentive either from tax-free appreciation or avoidance of exit taxes. LIHTC projects in areas with increasing rents or projects with project-based Section 8 contracts may experience significant appreciation over the project life. For such projects, the ability to step up their basis to fair market value and then sell the project after ten years (often 15 years for LIHTC projects due to their 15-year compliance period[4]) can result in no taxes on the profits and can be a significant benefit.

Avoidance of Exit Taxes. The appreciation of many other LIHTC projects may be small or nonexistent due to limited cash flow from low-income rents. These low-appreciation QOZB projects may still benefit from the OZ incentive by being able to avoid exit taxes. Due to limited equity in some LIHTC projects, especially projects financed with tax-exempt bonds, such projects may have LIHTC investors that are allocated losses in excess of their capital contributions resulting in a negative capital account. Normally such investors would owe tax upon exit from a LIHTC partnership, and often the general partner in the LIHTC partnership may bear the cost of the exit taxes. However, the OZ incentive can avoid these exit taxes where the LIHTC partnership is a QOZB. As discussed in more detail later in this chapter, after satisfying a ten-year OZ holding period, OZ investors can step up the tax basis of their QOF interest (or their basis in the QOZB partnership interest or the basis of the QOZB's assets). Special OZ rules provide that the step up to fair market value includes debt on a QOZB project.[5] The result can be a significant basis step-up that results in the avoidance of exit taxes, thus saving investors or general partners a significant cost when the project is sold.

Reduced Taxes Due on December 31, 2026, for Projects with Low Fair Market Value. While it is commonly said that the deferred capital gains tax is due no later than December 31, 2026 (or 85 or 90 percent of such tax for investments held seven or five years), there is a technical way that less tax can be due. As discussed in more detail later, if the QOF has lost value, then the amount of taxes due can be reduced. This appears to be a commonsense result to the effect that if a QOF investment has lost value, then the deferred capital gains taxes due from an investor should be similarly reduced.

Because many LIHTC projects have little value other than their tax credits, it could be possible for the fair market value of a LIHTC project on December 31, 2026, to be significantly lower than the cost to construct it. For example, a project completed and rented up in 2021 could have already delivered six of the ten years of LIHTC. Thus, 60 percent of the value of the project may no longer exist. This could significantly reduce the capital gains taxes due no later than December 31, 2026. However, as discussed in more detail later in this chapter, when a QOF is a partnership, the Regulations interpret the statutory fair market value in a way that narrows this ability to avoid some of the deferred capital gains taxes where QOFs or QOZBs use debt to finance distributions or taxable losses.[6] While this special rule can diminish the reduction in taxes due no later than the end of 2026, it is

4. I.R.C. § 42(i)(1).
5. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i).
6. Treas. Reg. § 1.1400Z2(b)-1(e)(4).

still possible that a low fair market value could lead to less taxes being due in 2026 than the deferred capital gains taxes (less 10 or 15 percent in basis earned at years five and seven).

Early Equity Can Lead to Possible Reduced Construction Interest. As discussed later, OZ Investors are required to invest their capital earlier than is normal for LIHTC or affordable housing development more generally. While the partnership agreement for the QOZB entity will likely include milestones for when the equity can be spent, it may be possible to negotiate with investor to allow some of that early capital to be used for construction, thus reducing interest on construction loans.

Pricing and Expanded Investor Base. The authors' experience has been that having a LIHTC project also qualify for OZ has led to modest or no change to the price per tax credit. There have been some situations where the OZ incentive availability did make a project appeal to a wider investor base than would have been available for a LIHTC project without OZ. There have also been situations where adding OZ to a transaction was a way to recapture yield for the investor where such yield may have suffered due to other changes in the project as it headed toward a closing with the investor.

3. Difficulties of Pairing OZs with LIHTC

Capital Contribution Timing Issues. The investor requirement to invest eligible gains within 180 days of realization of those gains, will often mean OZ investors fully fund their capital upfront. This works against the common LIHTC structure of deferring capital contributions to maximize investor yield/credit pricing.

Few LIHTC Investors with Capital Gain. One of the hardest parts of using OZ with a LIHTC investor is that the typical LIHTC investor is a financial institution, often a bank. Although there are exceptions, most banks do not generate capital gains as a regular part of their business and thus it can be hard to find a LIHTC-OZ investor. However, some banks have occasional capital gains that can be used. LIHTC exit gains can also provide a small pipeline of capital gains that could work with the OZ incentive.

4. What LIHTC Projects Work Best with OZ

The complex combination of OZ and LIHTC rules limits the types of LIHTC Projects for which OZs would be beneficial. Some general rules of thumb follow.

New Construction. New construction avoids the OZ-specific doubling of basis requirement for substantial rehabilitations, and is therefore more likely to work with OZs.

Very Substantial Rehabilitation. For existing buildings, the OZ rules require the owner to double the basis of an acquired building. This means that light or even some moderate rehabilitations are not compatible with OZ, but buildings requiring significant rehabilitation may be compatible.

Projects That Need Debt. A significant part of the return a LIHTC investor receives is from the ability to utilize taxable losses (often from large depreciation expenses) generated by a LIHTC partnership. Under the mechanics of the OZ incentive (discussed in detail *infra*), OZ investors initially receive $0 in basis in their interests in the QOF until December 31, 2026, when the deferred capital gains tax is due. Due to this lack of tax basis, tax rules around allocation of partnership losses often result in OZ investors not being able to use taxable losses unless there is project debt that could be allocated to them and give them tax basis. Thus, debt may allow the investor to use the taxable losses. Such debt would

generally need to be third-party non-recourse debt, which is not guaranteed by the general partner of the LIHTC partnership.[7]

B. LIHTC Developers' Use of OZ

LIHTC developers who have capital gain can also benefit from the OZ incentive if they are investing capital. The developer would form its own QOF, making sure the QOF is a partnership with at least two partners.[8] That QOF would then be the general partner or a special limited partner in the LIHTC partnership that would be the QOZB. In this way, taxes can be deferred on capital gains that the developer contributes to the QOF and that the QOF contributes QOZB. In addition, profits that the developer receives when the project is sold after at least ten years (and usually 15 years for LIHTC deals) could be received tax free. Using the foregoing structure can be very attractive to developers. Unlike most LIHTC investors, LIHTC developers value long-term appreciation of projects.

Caution and careful structuring are important in trying to maximize OZ benefits for developers. Developers commonly receive their interest in a LIHTC partnership for rendering services to the partnership. However, such a structure—services for a partnership interest—would not qualify as a proper investment by a developer's QOF because QOFs have to receive QOZB partnership interests solely in exchange for cash. If the developer's QOF receives an interest in the LIHTC QOZB for both cash contributed and for services rendered, then a portion of the investment would not qualify for OZ benefits. In such cases it might be prudent to structure the developer QOF's cash investment as a special limited partner interest in the LIHTC-QOZB partnership. The interest in the LIHTC-QOZB partnership that is received for service rendered could be classified as the general partner interest in the LIHTC-QOZB partnership and could be owned by the developer directly rather than through the QOF. It would also be recommended to do financial modeling or engage a valuation professional to demonstrate that the expected back-end value to be received by the QOF is commensurate with the capital invested and isn't disguised remuneration for services rendered.

C. OZ Equity as Non-LIHTC Investor

It can be possible to bring in OZ equity as its own layer of equity in both LIHTC projects and non-LIHTC projects. The QOF is just a partner in the housing partnership that will be the QOZB and will receive an economic return for its participation. Generating sufficient return to be inviting for an OZ investor can be difficult for affordable housing projects given their low rents. This can be especially difficult for LIHTC projects as they tend to have even less cash flow. One possible approach might be to have the OZ equity take the place of secured debt in an OZ-LIHTC project. The OZ investors, through their interest in the QOF, could then get a preferred return and there could be a cash out refinance after 10 to 15 years. However, care must be used in this approach. A QOF's investment in a QOZB

7. *See* Glenn A. Graff, *Why Does My Tax Lawyer Keep Saying We Need Nonrecourse Debt for My Low-Income Housing Tax Credit Project*, 27 J. Affordable Hous. 435 (2018).

8. The partners must be separate entities that are not disregarded into a common entity. Thus, for example, they cannot be two single-member LLCs treated as disregarded entities that are owned by the same person or entity.

len50412_complete.indb 227 1/13/22 8:40 AM

partnership must be a capital contribution and cannot be classified as a loan for tax purposes. Therefore, using OZ equity as a replacement for debt must be carefully structured so that the QOF's rights are not so similar to a lender's rights that the investment might be classified as debt by the IRS.

D. OZ with Historic Tax Credits

The OZ incentive can pair nicely with the historic rehabilitation tax credit (HTC) available under Code Section 47. This can work for both residential rental housing or for commercial developments. Similar to OZ-LIHTC structures, an investor could receive the benefit of HTCs and the OZ incentive. This can increase the return to the investor resulting in a noticeable increase in equity invested in the project. However, because HTC projects often have more substantial economic returns than LIHTC projects, there is a greater ability for other non-HTC users to participate by investing OZ equity. An HTC developer might want to set up its own QOF to invest in the HTC-QOZB partnership, thus deferring capital gain and allowing some long-term profits to escape taxation. There may also be sufficient return to incentivize an OZ investor to invest as a separate layer of financing and allow the HTCs to be allocated to a different investor.

Some historic tax credit transactions are structured as lease passthroughs, where the building is owned by one entity but is leased to a master tenant partnership and the tax credits are passed through to the master tenant partnership.[9] Such leases are generally structured as triple-net leases where the terms of the lease provide that the tenant bears the cost of taxes, insurance, and maintenance. However, as discussed later in this chapter, under the OZ regulations, a business cannot qualify as a QOZB if it is merely a landlord entering into a triple-net lease.[10] Because of this, care must be used in lease passthrough structures so that the leases are not triple-net leases.

E. OZ with New Markets Tax Credits

It is theoretically possible to use the OZ incentive with New Markets Tax Credits (NMTC). However, successfully structuring this can be very difficult; NMTC investments are generally structured as loans, but the OZ incentive is available only for equity investments. There are sometimes NMTC investments structured as equity rather than a loan, however such structures are very rare and create some negative implications for NMTC investors.[11] Another restriction is that NMTC is only available for nonresidential rental housing. As

9. *See* Treas. Reg. § 1.48-4 (Election of lessor of new Section 48 property to treat lessee as purchaser). "A Master Tenant Partnership is a Partnership that leases a Building from Developer Partnership (Head Lease) and for which an election is made pursuant to Treas. Reg. Section 1.148-4(a)(1) to treat the Master Tenant Partnership as having acquired the Building solely for purposes of the § 47 rehabilitation credit)." Rev. Proc. 2014-12.

10. Treas. Reg. § 1.400Z2(d)-1(d)(3)(iii)(B).

11. The reasonable expectations test under Treas. Reg. § 1.45(D)-1(d)(6)(i) is not available if the community development entity (CDE) has control of the qualified active low-income community business (QALICB). Control exists if the CDE has 50 percent or more of the value of the QALICB or 50 percent or more of voting or management rights. Treas. Reg. § 1.45(D)-1(d)(6)(i)(B). In an OZ transaction, the QALICB would also be the QOZB partnership. However, if the OZ investor invests OZ equity in the QALICB/QOZB partnership but also receives NMTCs thorough an investment in the CDE, then it may be deemed to have control if it has 50 percent or more of the equity or voting/management rights in the QALICB/QOZB.

a result, an OZ-NMTC project needs to be a nonresidential commercial development or a residential rental development with significant commercial portions such that less than 80 percent of the gross rent would come from dwelling units.

F. OZ with Workforce Housing

A popular use of OZ equity is for workforce housing. Workforce housing is commonly referred to as housing for people with up to 80 percent of area median gross income. Such housing generally doesn't qualify for LIHTCs, but because of increased rental income, there can be enough economics to be a viable OZ investment. Workforce housing also can generate Community Reinvestment Act[12] (CRA) credit and therefore this can be an attractive investment for banks generally where at least half of the units will qualify as workforce housing. Workforce housing can also work well in combination with HTCs or NMTCs.

G. Socially Motivated Investors

In all of the preceding types of transactions involving affordable housing and OZ investing, it can be very helpful to look for investors who are "socially motivated" investors. While such investors generally still look for a significant economic return on their investment, they are often willing to take a lower return than other non-socially motivated investors. While banks looking for CRA investments are one such investor, there are also other non-CRA investors who are socially motivated.

III. DETAILED ANALYSIS OF OPPORTUNITY ZONE INCENTIVE

A. Qualified Opportunity Zones

As previously stated, the Tax Cuts and Jobs Act (TCJA) of 2017 created the OZ incentive in order to spur long-term economic investment in low-income areas. The TCJA specified the criteria and designation process for these low-income areas, called qualified opportunity zones (QOZs).[13] These are census tract-based designations. To be eligible for designation as a QOZ, a census tract had to be a low-income community as determined by the 2010 census. A tract is low-income if its residents have a poverty rate of 20 percent or higher; or if the median family income within the tract is not more than 80 percent of the statewide or metropolitan area median.[14] A limited number of tracts adjacent to low-income communities could also be designated as QOZs if that tract's median family income was not more than 125 percent of the adjacent low-income tract's median family income, and the adjacent low-income tract was designated as a QOZ.

The reasonable expectations test allows an entity to be treated as a QALICB during the duration of a CDE's investment if, at the time of investment, the CDE reasonably expects the entity will satisfy QALICB requirements throughout the period of investment or loan. Where the reasonable expectations test is not available, the purported QALICB must meet various tests throughout the period of CDE control. For further discussion, see NOVOGRADAC & COMPANY LLP, NEW MARKET TAX CREDITS HANDBOOK: A TAX CREDIT PRACTITIONERS GUIDE TO USING NEW MARKET TAX CREDITS TO PROVIDE INVESTMENTS IN LOW-INCOME COMMUNITIES Ch. 2.08[1][e] (2019 ed.).

12. 12 U.S.C. § 2901.

13. *See* I.R.C. § 1400Z-1.

14. This is the same definition for a "low-income community" as in the New Markets Tax Credit program.

In the 2010 census, there were 74,001 census tracts, with 31,680 meeting the low-income definition. Generally, from the low-income census tracts therein, the chief executive[15] of each U.S. state, possession, and territory was permitted to nominate as QOZs as many as 25 percent of the number of low-income tracts (but at least 25 low-income tracts). The exception, under 2018 legislation, is that every low-income census tract in Puerto Rico is a QOZ,[16] which is the vast majority of the island.

Between December 22, 2017, and March 22, 2018, governors nominated tracts as QOZs by notifying the Secretary of the Treasury of the nomination via an online nomination tool. After this, the Secretary of the Treasury had 30 days to certify the nominations and designate the tracts. Governors could request a 30-day extension for either or both of the determination period and the Secretary's consideration period. Notice 2018-48, as modified by Notice 2019-42, lists all of the census tracts that have been designated as QOZs. Whether an address is within a QOZ can be determined by going to https://opportunityzones.hud.gov/resources/map.

The designation of a census tract as a QOZ remains in effect until December 31, 2028. The ability for investors to qualify for the ten-year hold benefit is not hurt by the expiration of the zone designations at the end of 2028: despite zone designation expiration, a qualified QOF investment can still grow tax free to an investor through 2047. However, if a QOF sold a QOZB investment after December 31, 2028, it appears that it would not be able to make a new QOZB investment because the QOZ status of the census tracts would have expired.

The 2020 census led to some census tract boundaries changing, the merging of some census tracts, and the split of other census tracts. IRS Announcement 2021-10 confirmed that the census tract boundaries in effect when the QOZ designations were made are the boundaries that control and are not subject to change. As a result, changes in the 2020 census do not impact whether or not a location is considered to be in a QOZ.

B. Gain Deferral and Exclusion Benefits

The term "investor" is used in this chapter to describe an eligible taxpayer that has timely invested eligible gains in a QOF and elected to defer capital gains taxation of the invested gains. This section will first will discuss each of these terms—eligible taxpayer, eligible gains, and timely investment—and then the election an eligible taxpayer must make in order to take advantage of the OZ incentive.

1. Requirements to be Eligible for the OZ Incentive

Eligible Taxpayers. The OZ incentive is available to "eligible taxpayers," as defined in the final Treasury regulations. Generally, an eligible taxpayer is defined as a person who is required, under federal income tax principals, to report the recognition of gains during the taxable year. This can include individuals, C corporations, regulated investment companies

15. This is generally a governor; in the case of Washington, D.C.'s QOZ nominations, it was the mayor.

16. I.R.C. § 1400Z-1(b)(3).

(RICs), real estate investment companies (REITs), partnerships, S corporations, trusts, and decedents' estates.[17]

Under the OZ rules, the party that has the capital gain generally has to be the party that makes the investment in a QOF. However, the final OZ Regulations provide an important exception whereby one consolidated corporate group member can invest the eligible gains of a different member.[18] This is critical in the LIHTC industry, where the largest investors tend to be banks. Many banks organize their LIHTC investments in a single corporate subsidiary, which is a community development corporation (CDC).[19] However, bank capital gains generally come from other members of the bank consolidated group. Thus, for such bank consolidated groups and other consolidated groups operating in heavily regulated industries, it was a significant help that the final Regulations allow one consolidated member to have a capital gain but for a different member to make an investment in a QOF.

Eligible Gain. To be an "eligible gain" the gain (1) must be a capital gain, (2) from an unrelated party,[20] and (3) would have be recognized and subject to tax by December 31, 2026. The Regulations have interpreted capital gains to include qualified gains under Code Section 1231 (certain gains from the sale of real property or depreciable business property). Gains can be invested on a gross basis; that is, without reducing gains for any losses incurred or carried over to the tax year.[21]

Timing Requirements. An eligible taxpayer's investment of eligible gains must be timely in order to benefit from the OZ incentive. For gains directly realized by an eligible taxpayer, the eligible gain must be invested in a QOF within a 180-day period beginning on the day on which the gain would otherwise have been recognized for federal income tax purposes.[22]

Where a gain is realized by a partnership, itself an eligible taxpayer, the Regulations provide significant flexibility. First, the partnership entity may invest the gain within 180 days of the gain being realized. If the partnership does not invest the gain, the partners may invest some or all of their distributive share of the gain instead. Where partners invest the gain, the 180-day period generally begins on the last day of the partnership's tax year. Alternatively, the owner may elect to treat the beginning of their 180 period as

- the same as the partnership's 180-day period; or
- the 180-day period beginning on the due date for the partnership's tax return, without extensions, for the tax year in which the partnership realized the gain.

17. Non-U.S. taxpayers with effectively connected eligible gains to which the taxpayer does not elect to apply a treaty exemption can benefit from OZ investing. Treas. Reg. § 1.1400Z2(a)-1(b)(11)(ix)(A)(1). Similarly, resident individuals of U.S. territories (e.g., Puerto Rico) who file a U.S. tax return can make a deferral election, but only with respect to gains not derived within their territory of residence. Proposed regulations address FIRPTA withholding mechanics, though this remains an area of uncertainty.

18. Treas. Reg. § 1.1502-14Z.

19. See https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-fact-sheets/ca-fact-sheet-bank-owned-comm-dev-corp-sep-2011.html for a discussion of the use of CDCs.

20. For purposes of OZs, two legal entities can be considered related parties if there is more than 20 percent common ownership. I.R.C. § 1400Z-2(e)(2). Familial relationships can also cause parties to be considered related. See cross reference to I.R.C. § 267 in I.R.C. § 1400Z-2(e)(2).

21. Treas. Reg. § 1.1400Z2(a)-1(b)(11).

22. *Id.* § 1.1400Z2(a)-1(b)(7).

Similar rules apply to S corporations, non-grantor trusts, and estates.[23]

With the COVID-19 pandemic, investors were provided additional time to invest eligible gains in a QOF. The IRS released Notice 2021-10, which allowed taxpayers until March 31, 2021, to invest gains where the taxpayer's last day of their 180-day window was between April 1, 2020, and March 31, 2021.

Deferral Election. Qualification for OZ tax benefits is not automatic; an eligible taxpayer must elect to defer tax on capital gains invested in a QOF.[24] Interestingly, there is no tracing of funds. There is no need to show that the exact funds that created the capital gain are the same funds that are invested in a QOF. It is enough merely to have a gain, to make a timely investment in a QOF, and then to elect to defer taxation of some or all of the capital gain. The election to defer taxation of the capital gain is considered a regulatory election and is initially made on Form 8949, with QOF holdings reported on Form 8997, to be filed with the taxpayer's return for the year in which the gain would otherwise be included.[25] The investor must continue to include Form 8997 with its return in every year in which the investor owns an interest in a QOF.

2. Tax Benefits of Opportunity Zones Investing

By investing in a QOF, an investor can realize three tax benefits:

- Deferred taxation on the invested gain;
- Permanent exclusion of some of the invested gain from taxation; and
- Unrecaptured losses and tax-free growth of the QOF investment.

Deferred Taxation of Invested Gain. An investor defers taxation of invested gain until the earlier of an inclusion event or December 31, 2026.[26] Numerous events can result in an inclusion event. Where an investor transfers all or a portion of its investment in a QOF, this is an inclusion event to the extent the investor's equity interest is reduced. Thus, if an investor sells, exchanges, or gifts part or all of its qualifying investment in a QOF prior to having recognized all of the deferred gain associated with that investment, the sale or exchange is an inclusion event, which the investor should generally report via Form 8949, with changes to QOF investment amounts reported on Form 8997.

Distributions of Property or Cash as an Inclusion Event. Generally, if a taxpayer receives property (including money) from a QOF, and that property receipt is treated as a distribution for federal income tax purposes, it is an inclusion event.[27] This is generally the case regardless of whether the receipt of property reduces the investor's ownership in the QOF. However, distributions from a QOF partnership that do not exceed a QOF partner's adjusted basis in its QOF partnership interest are not inclusion events.[28] An example of

23. *Id.* § 1.1400Z2(a)-1(b)(7)(iii).
24. *Id.* § 1.1400Z2(a)-1(a)(2).
25. The election made on Form 8949 is a regulatory election. The IRS has, in one circumstance at the time of writing, granted Treas. Reg. § 301.9100 relief to an investor who erred in filing or completing its initial Form 8949. PLR 202021009. Thus, missing the election may be fixable, but at the time of writing, the fix is to request a private letter ruling—a time-intensive and expensive process.
26. At the time of writing, legislative proposals exist to extend this date to allow later investments in QOFs to have a long enough investment timeline to benefit from the five- and seven-year gain exclusion provision.
27. Treas. Reg. § 1.1400Z2(b)-1(b).
28. *Id.* § 1.1400Z2(b)-1(c)(1)(i).

this would be a debt-financed distribution of cash to an investor, where the additional debt creates basis for the taxpayer, thus sheltering the distribution from taxation and inclusion. However care must be taken with respect to debt-financed distributions, as special OZ rules can treat such distributions as a disguised sale rather than capital contributions.[29] Such treatment would result in a portion of the investment in the QOF not qualifying for OZ treatment. It is generally recommended that debt-financed distributions occur more than two years after the last investor contribution into a QOF in order to avoid the presumption of a disguised sale.[30]

Worthless Stock or QOF Cessation as Inclusion Event. If an investor claims a loss for worthless stock under Section 165(g) or otherwise claims a worthlessness deduction with respect to its QOF investment, the investor is treated as disposing of that portion of the taxpayer's qualifying investment.[31] Finally, if an eligible entity ceases to be a QOF, that is an inclusion event to the investors, and triggers recognition of previously deferred gain with respect to qualifying investments in the QOF.[32]

Calculation of Capital Gains Recognized. When an inclusion event or the December 31, 2026 date triggers gain recognition, the amount of gain an investor includes in their income is limited to the remaining amount of deferred gain reduced by the 10 or 15 percent basis adjustments discussed later.[33] The gain recognized may be further limited where the QOF investment lost value: If the fair market value of the portion of the investment disposed of (or of the QOF investment as a whole at December 31, 2026) is less than the remaining proportional amount of deferred gain, the amount recognized upon the inclusion event is the fair market value of the portion of the qualifying investment disposed of less the investor's basis in the portion of the disposed investment.

Regulation 1.1400Z2(b)-1(e)(4) provides a special rule that applies to QOF partnerships and S corporations when computing the amount gain from an inclusion event. Investors must compare the remaining amount of deferred gain (possibly reduced 10 to 15 percent for timely holding QOF investments for five to seven years) to gain that would be recognized on a fully taxable disposition of the investment or portion of investment disposed.[34] This modification to the fair market value limitation appears to be intended to prevent investors from intentionally reducing the fair market value of investments in QOF partnerships through debt-financed distributions that would not otherwise trigger an inclusion event or from using the tax basis provided by debt to allow deductions that the investors would not otherwise have been able to access.

Short-Term versus Long-Term Capital Gain. The attributes of the capital gain deferred as long- or short-term are preserved when eventually included in an investor's income.[35] So, if an investor defers short-term capital gain, the gain remains short-term capital gain when it is later included, regardless of how long the investor holds the QOF investment. However, the tax provisions and rates that apply at inclusion are those that prevail at

---

29. *See id.* § 1.1400Z2-(a)-1(c)(5)(iii)(A).
30. *See id.* § 1.707-3(c).
31. Treas. Reg. § 1.1400Z2(b)-1(c)(iii) & (c)(14).
32. *Id.* § 1.1400Z2(b)-1(c)(iv).
33. I.R.C. § 1400Z-2(b)(2); Treas. Reg. § 1.1400Z2(b)-1(e)(1).
34. Treas. Reg. § 1.1400Z2(b)-1(e)(4).
35. *Id.* § 1.1400Z2(a)-1(c)(i).

the time of inclusion.[36] That is, gain realized in 2018 and timely invested in a QOF, if held by the investor through December 31, 2026, will be taxed at 2026 rates. This presents some investor risk that their invested gains may be taxed at a higher rate than they would have been were the OZ investment not made. However, this risk is offset by the deferral benefit, the possible avoidance of 10 to 15 percent of capital gain tax, and the potential for tax-free growth at higher rates.

3. Ten to Fifteen Percent Permanent Exclusion of Some Invested Gains from Taxation

When an investor first invests its deferred-tax gain into a QOF, its federal tax basis in its QOF interest is zero.[37] If, by December 31, 2026, an investor has held its interest in the QOF for at least five years, the investor receives a basis increase in its investment equal to 10 percent of the deferred gains invested.[38] This permanently excludes 10 percent of the original deferred gain from taxation.[39] If, by December 31, 2026, an investor has held its interest in the QOF for at least seven years, the investor receives an additional basis increase of 5 percent of the deferred gains invested, permanently excluding a total of 15 percent of the original deferred gain from taxation.[40]

As of the date of writing, a new QOF investor would not have sufficient time before the gain inclusion date of December 31, 2026, to benefit from the seven-year basis increase (unless Congress were to extend the gain inclusion date). However, this does not detract from what many view as the most attractive benefits of long-term Opportunity Zone investment—unrecaptured depreciation and tax-free growth.

4. Unrecaptured Depreciation and Tax-Free Growth of the QOF Investment—The 10-Year Hold Benefit

Where an investor holds its QOF investment at least ten years, the investor can elect to have the basis of its QOF interest equal the fair market value of its QOF interest on the date the QOF interest is sold or exchanged.[41] This benefit permanently excludes from taxation any unrecaptured depreciation and post-acquisition gain in the QOF investment. Where an investor holds its QOF investment in a QOF partnership or QOF S corporation for at least ten years, and the QOF, or any partnership that is owned directly or indirectly by the QOF solely through one of more partnerships, sells or exchanges property, the investor can elect to exclude from its gross income all gains and losses allocable to the disposal of qualifying investment.[42]

In LIHTC transactions, an additional boon can be had. As mentioned *supra*, it is not uncommon for the LIHTC investor to incur "exit taxes" when getting out of a LIHTC investment, due to the investor having taken losses—generally related to large depreciation deductions—in excess of the amount invested, leading to a negative capital account (i.e., debt-financed losses). This is especially common for projects qualifying for 4 percent

36. *Id*. § 1.1400Z2(a)-1(c)(ii).
37. I.R.C. § 1400Z-2(b)(2)(B)(i).
38. *Id*. § 1400Z-2(b)(2)(B)(iii).
39. *See id*. § 1400Z-2(b)(2)(A)(ii) (basis in investment reduces amount of gain).
40. I.R.C. § 1400Z-2(b)(2)(B)(iii).
41. *Id*. § 1400Z-2(c).
42. Treas. Reg. § 1.1400Z2(c)-1(b)(2).

len50412_complete.indb 234 1/13/22 8:40 AM

tax credits through the use of tax-exempt bond financing because such projects have less investor capital to debt than projects that are allocated 9 percent tax credits. However, the OZ rules provide that the step up to fair market value of the interest is tax free and thus exit taxes are avoided. In addition, even if the fair market value of the LIHTC project is low, as often may be the case of LIHTC projects that have limited economics, the OZ rules provide that the fair market value computation includes debt on the LIHTC project.[43] This rule means that even low-value projects can avoid exit taxes.

The Treasury Regulations provide that investors can only make fair market value basis step-up elections until December 31, 2047. There is no such provision in the Code. This regulatory deadline may create an OZ market sell-off with potential diminishing effects on the OZ communities as large numbers of investors may choose to sell their investment in 2047 in order to benefit from the fair market value basis adjustment. Congress is aware of this issue, and is considering potential "fixes," including the ability of investors to declare a date for basis step-up without requiring actual sale or exchange of their QOF interest.

5. Mixed Funds Investments

Only a qualifying investment, that is, an investment of deferred gain, is eligible for Opportunity Zone tax benefits. A taxpayer is permitted to make a nonqualifying investment in a QOF—an investment made with something other than deferred gain—but the tax benefits are available only with respect to an investment made with deferred gain.[44] If a taxpayer makes investments in a QOF and only a portion of those investments are investments of deferred gain, the taxpayer is treated as owning two separate investments in the QOF: a qualifying portion and a nonqualifying portion that must be tracked separately over the life of the investment. Only the qualifying portion is eligible for the OZ tax benefits.

C. Qualified Opportunity Funds

To qualify for opportunity zone tax benefits, a taxpayer must timely invest eligible gain in a QOF.[45] A QOF is defined as an investment vehicle organized as a corporation or partnership for the purpose of investing in QOZP, and that holds at least 90 percent of its assets in QOZP.[46] At the time of writing, a fund-of-funds structure is not permitted, as interests in a QOF do not constitute QOZP. We discuss QOZP in greater detail *infra*.

A QOF must self-certify its status as such by filing Form 8996 with its tax return each year.[47] In the first year of operation, it is generally advisable that the QOF select the month during which it first received a qualified investment as its first month as a QOF; this ensures that the investor's qualified investment is treated as having been made to a QOF, and permits the maximum amount of time before the QOF's first testing date (testing dates discussed further *infra*). The IRS considers the Form 8996 certification to be a regulatory election and has, in specific circumstances, granted Regulation 301.9100 relief to a QOF that erred in filing or completing its initial Form 8996.[48] Thus, missing the QOF

43. *Id.*
44. I.R.C. § 1400Z-2(e)(1).
45. *Id*. § 1400Z-2(a)(1)(A).
46. *Id*. § 1400Z-2(d)(1).
47. Treas. Reg. § 1.1400Z2(d)-1(a)(2).
48. *See, e.g.*, PLRs 202019017, 202116011, 202103013, and 202119003.

certification may be fixable, but at the time of writing, the fix is to request a private letter ruling—a time-intensive and expensive process.

1. The 90 Percent Investment Standard ("90 Percent Test")

A QOF must maintain the 90 percent investment standard, which is reported annually via Form 8996. The measurement is an average of the QOZP percentage held at two testing dates: the last day of the first six-month period of the QOF's tax year and the last day of the QOF's tax year.[49] By way of example, this means that a QOF first certifying as a QOF for May 2021 has a testing date each at October 31, 2021, and at its December 31, 2021 tax year end. If an eligible entity becomes a QOF in the seventh or later month of a taxable year, the 90 percent investment standard would only take into account the assets held on the last day of the QOF's taxable year.[50]

At each testing date, the fund determines the percentage of its assets held in QOZP. Where a QOF fails to meet the 90 Percent Test and does not establish reasonable cause for the failure, the QOF is required to pay a penalty which accrues monthly.[51] In theory, repeated failures may allow the IRS to take action to decertify a fund, though the mechanics of such a forced decertification are not specified in the Code or Treasury Regulations, and have not yet been tested.

For purposes of the 90 Percent Test, a QOF has the option to disregard contributions received not more than six months before a testing date, if those contributions are held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.[52] This provides a QOF time to deploy contributions and could yield as much as nearly a year to deploy contributions, depending on receipt. To illustrate, suppose a December 31 year-end QOF receives a contribution on January 2. This contribution can be disregarded at the June 30 testing date, in which case the QOF has until December 31 to invest those newly contributed funds into QOZP.

At their first testing date, new QOFs may need to choose to disregard all contributions received to-date if the funds have not yet been invested.[53] This yields two potential problems. first, the ratio at the first testing date of QOZP over total assets may be $0/$0, an undefined number. Second, to the extent those contributions were deposited into an interest-bearing account and earned interest, might those earnings create assets that cannot be disregarded, such that the QOF's percentage of assets invested in QOZP is zero percent? The IRS has yet to provide formal guidance on these issues but has indicated informally that a QOF should report 100 percent for the $0/$0 situation, and should be permitted to exclude interest earned on contributions received within six months prior to a testing date.

49. I.R.C. § 1400Z-2(d)(1).

50. *Id*. § 1400Z-2(d)(1).

51. *Id*. § 1400Z-2(f)(1). Notice 2021-10 provides reasonable cause penalty relief for QOFs impacted by the COVID-19 pandemic where a testing date falls between April 1, 2020, and June 30, 2021. Form 8996 must still be completed in full, including computations of penalty amounts, but with $0 entered as the penalty total.

52. Treas. Reg. § 1.1400Z2(d)-1(b)(2)(B).

53. *Id.*

2. Valuation Method

To measure for the 90 Percent Test, a QOF may value its assets according to financial statements (the "applicable financial statement method"), or using the "alternative valuation method,"[54] under which the unadjusted cost basis of assets is generally used.[55] Financial statement valuation is only available if the financial statements provide GAAP-based valuations, and if the financial statements value assets at least annually, recognize "mark-to-market" income arising from these valuations, and require a mark-to-market based realization of income on the disposal of assets.[56]

Unadjusted cost basis means that for valuation purposes one would look at the original basis (generally the original cost) of the asset without adjusting for subsequent depreciation.[57] Unadjusted cost basis valuation tends to be more attractive for a number of reasons. First, not all QOFs will have financial statements meeting the applicable financial statement method requirements. Perhaps more importantly, using unadjusted cost basis provides longer-term dependability. Using the unadjusted cost basis approach, a QOF does not have to worry about depreciation or fluctuations in the value of assets impacting the 90 Percent Test. However, if property was not purchased or constructed for fair market value (for example, contributed property), the unadjusted cost basis approach to valuation cannot be used; instead, the asset's value for purposes of the 90 Percent Test is the asset's fair market value on each testing date.

In the case of leased property, the value under the alternative valuation method is the present value of each payment to be made under the lease, inclusive of amount-certain payments that would be made under any lease extension terms available at the time the lease is entered into.[58] The value under this approach is determined at the time the lease is entered into and holds for the duration of the lease. That is, a new value does not need to be determined as time passes (and therefore the number of lease payments to be made decreases).

D. Qualified Opportunity Zone Property

QOZP includes (1) QOZ stock, (2) QOZ partnership interests, and (3) QOZ business property (QOZBP).[59] While it is possible for a QOF to directly own QOZBP and directly operate a trade or business, this is extremely rare. The reason is twofold: first, a qualified opportunity zone business (QOZB) can benefit from working capital safe harbor periods that generally permit a QOZB up to 31 months to use the cash that is invested in the QOZB. This 31-month working capital rule (discussed *infra*) does not apply where the QOF directly owns property rather than indirectly owning property by investing in a corporation or partnership that owns the property used in a trade or business. Second, where a QOF must maintain a 90 percent investment standard, a QOZB must maintain a more forgiving 70 percent tangible property standard (discussed *infra*).

54. *Id*. § 1.1400Z2(d)-1(b)(3).
55. *Id*. § 1.1400Z2(d)-1(b)(4).
56. *Id*. § 1.1400Z2(d)-1(b)(3)(ii).
57. *Id*. § 1.1400Z2(d)-1(b)(4).
58. *Id*. § 1.1400Z2(d)-1(b)(4)(iii).
59. I.R.C. § 1400Z-2(d)(2)(A).

len50412_complete.indb 237 1/13/22 8:40 AM

1. QOZ Stock

QOZ stock is stock in a domestic entity classified as a corporation for federal tax purposes, acquired after December 31, 2017, at its original issue from the corporation solely in exchange for cash.[60] To qualify, the issuer must be a QOZB or, if the corporation is newly formed, it must have been organized for purposes of being a QOZB. Further, during substantially all (at least 90 percent) of the QOF's holding period for the stock, the corporation must qualify as a QOZB.

Although QOZ stock constitutes QOZP and is thereby a "good" asset for purposes of a QOF's 90 percent investment standard, QOZ stock is rarely used in real estate investing: The corporate form does not allow for investors to receive passthrough depreciation deductions.

2. QOZ Partnership Interest

QOZ partnership interests are the principal method of investing in OZ-sited real estate projects. A QOZ partnership interest is a capital or profits interest in a domestic entity classified as a partnership for federal tax purposes, acquired after December 31, 2017, from the partnership solely in exchange for cash.[61] Similar to QOZ stock, at the time the QOF acquired the interest, the partnership must be a QOZB or, if the partnership is newly formed, it must have been organized for purposes of being a QOZB. Again, during substantially all (at least 90 percent) of the QOF's holding period for the interest, the partnership must qualify as a QOZB.[62]

For both QOZ stock and QOZ partnership interests, the interest needs to be equity. Preferred stock is permissible, as are partnership interests, which receive special allocations. However, the rights associated with the interest should not bear too many similarities to debt, such as a fixed rate of return or repayment date.

3. QOZBP

QOZBP is defined as tangible property, purchased or leased, used in a trade or business that meets the following requirements:[63]

- Purchased after December 31, 2017, from an unrelated person;
- Original use of the property in the QOZ commences with the QOF (or the QOZB), or the QOF (or QOZB) substantially improves the property; and
- During at least 90 percent of the QOF's (or QOZB's) holding period for the property, at least 70 percent of the use of the property is in the QOZ.

The substantial improvement requirement is met if, during any 30-month period beginning after the date of acquisition of the property, additions to the basis of the property in the hands of the QOF (or QOZB) exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF (or QOZB).[64]

60. *Id*. § 1400Z-2(d)(2)(B).
61. *Id*. § 1400Z-2(d)(2)(C).
62. *Id.*
63. *Id*. § 1400Z-2(d)(2)(D).
64. I.R.C. § 1400Z-2(d)(2)(D)(ii).

In affordable housing, it is not uncommon for the developer to be related to the project-owning partnership (the project-owning partnership serving as the QOZB entity in the OZ context). The regulations are not clear as to whether reasonable payments from the QOZB to the related developer for the development or construction of tangible property constitute QOZBP.

Land generally does not need to be substantially improved.[65] That said, an unimproved piece of land does need to be used in a trade or business. Land will not be QOZBP if it is unimproved or minimally improved and was purchased with an expectation or intention not to improve it by more than an insubstantial amount within 30 months of acquisition.[66] It is not completely clear what "more than insubstantial" means: presumably something less than a doubling of the basis, with acceptable improvement examples in the final Treasury Regulations including clearing, remediating, and grading the land in preparation for its use.

Leased QOZBP must meet all of the following requirements:[67]

- Lease entered into after December 31, 2017, from a related or unrelated person;
- Generally, the lease terms must be market-rate;[68] and
- During at least 90 percent of the QOF's (or QOZB's) holding period for the property, at least 70 percent of the use of the property is in the QOZ.

Leased property is not subject to the "original use" or "substantial improvement" requirements; that is, a QOF or QOZB may lease property that had previously been used by another party within the QOZ. Improvements that a lessee makes to leased property satisfy the original use requirement as purchased property.

In the case of nonqualified property, the Code and Treasury Regulations are silent as to the treatment of improvements: Though the existing property is not QOZBP, might the improvements thereto qualify as QOZBP? Interestingly, one must look to the preamble to the final Treasury Regulations for an answer. A commenter pointed out that improvements to leased property are treated as separate property and reasoned that the same standard should apply to owned property. The Treasury did not agree, having "determined that the administrative burdens that would arise for taxpayers and the IRS from tracking improvements made to such non-qualified property would significantly exceed those arising from the tracking of lessee improvements."[69] At present, a QOZB or QOF should understand that improving nonqualified property may add to its non-QOZBP or non-QOZP assets, and threaten its ability to meet the 70 Percent Test (discussed *infra*) or 90 Percent Test. However, land is considered a separate asset from a building constructed on it. Thus, nonqualified land could have a new building constructed on it and that new building should not be considered nonqualified property merely because it was built on nonqualified land.

65. Treas. Reg. § 1400Z2(d)-2(b)(4)(iv)(B).

66. *Id*. § 1.1400Z2(d)-(2)(b)(4)(iv)(C).

67. *Id*. § 1400Z2(d)-2(c).

68. For leases between unrelated parties, the rebuttable assumption is that the terms are market rate. Related party leases must meet several additional requirements specified in the final Treasury regulations. In the case of leases of tangible property from a state, local, or Indian tribal government, the lease is treated as not between related parties.

69. IRS, Treasury Decision, TD 9889, 85 FR 1866, Investing in Qualified Opportunity Funds (2020).

E. Qualified Opportunity Zone Businesses (QOZB)

A business must meet several criteria at the end of its tax year to be a QOZB for that taxable year:

- A QOZB can be a new or existing entity but must be classified as a partnership or corporation for federal income tax purposes and organized under the laws of the United States.[70]
- The QOZB must be engaged in the active conduct of a trade or business.[71]
- The QOZB must meet the 70 percent tangible property standard; that is, at least 70 percent of the tangible property owned or leased by the QOZB must be QOZBP.[72]
- At least 50 percent of the QOZB's total gross income must be derived from the active conduct of a trade or business in the QOZ, or in multiple QOZs.[73]
- At least 40 percent of the QOZB's intangible property must be used in the active conduct of a trade or business in a QOZ.[74]
- Nonqualified financial property (NQFP) must constitute less than 5 percent of the QOZB's property.[75]
- The business of the QOZB may not involve operation of what is commonly called a "sin business": operating a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a racetrack, a gambling establishment, or a store if the principal business is the sale of alcohol for consumption off premises.[76]

1. Active Conduct of a Trade or Business

The Regulations specifically focus on the ownership and operation of real property and discuss what the bounds are for leasing activity to be considered the active conduct of a trade or business. Owning and leasing real property can constitute the active conduct of a trade or business, but "merely entering into a triple-net-lease" does not.[77]

The Regulations provide examples of this. In one, a company constructs, places into service, and leases out a building to one tenant, and the tenant is responsible under the lease for all taxes, insurance, and maintenance expenses related to the building. The company maintains a staffed office to address issues that may arise with respect to the lease but has no other property. The company is not engaged in the active conduct of a trade or business for purposes of Code Section 1400Z-2(d)(3)(A).[78] By contrast, the facts in a second example have a QOZB company that leases three different floors of a building to three different

70. Treas. Reg. §§ 1.1400Z2(d)-1(a)(1)(iii), 1.1400Z2(d)-1(a)(1)(i).
71. I.R.C. § 1400Z-2(d)(3)(A), Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iii).
72. I.R.C. § 1400Z-2(d)(3)(A)(i), Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i).
73. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(i).
74. *Id.* § 1.1400Z2(d)-1(d)(3)(ii)(A).
75. *Id.* § 1.1400Z2(d)-1(d)(3)(iv).
76. *Id.* § 1.1400Z2(d)-1(d)(4)(i). De minimis amounts (less than 5 percent) of gross income attributable to sin business activity is permitted. In a rental context, de minimis means that less than 5 percent of rentable square feet and less than 5 percent of the value for all other tangible property. *Id.* § 1.1400Z2(d)-1(d)(4)(ii)–(iii).
77. *Id.* § 1.400Z2(d)-1(d)(3)(iii)(B).
78. *Id.* § 1.1400Z2(d)-1(d)(3)(iii)(C), Example 1.

tenants. One floor is triple-net leased to a tenant, with the other two floors having leases that are not triple-net. For the non-triple-net leased floors, the company manages and operates the floors. The Regulations conclude that under these facts, the company is engaged in the active conduct of a trade or business for purposes of Code Section 1400Z-2(d)(3)(A).[79]

2. Seventy Percent Tangible Property Standard ("70 Percent Test")

Whether a trade or business of the entity satisfies the 70 Percent Test is determined by using a fraction, the numerator of which is the total value of all QOZBP owned or leased by the QOZB and the denominator of which is the total value of all tangible property owned or leased by the QOZB, whether located inside or outside of a QOZ.[80] The valuation methods available for this purpose are the same as those applied under the 90 Percent Test and discussed *supra*: the applicable financial statement method or the alternative valuation method.

3. Gross Income Test

In order for a business to be considered a QOZB, with respect to any tax year, at least 50 percent of its total gross income must be derived from the active conduct of a trade or business within QOZs.[81] By meeting any one of the following three safe harbors, a QOZB is considered to have met its Gross Income Test requirement.[82]

1. *Hours performed.* This safe harbor is met if, over the course of the year, at least 50 percent of services performed for the business by employees and independent contractors are performed within a QOZ. A ratio is used to determine whether this safe harbor is met, with the numerator equaling the number of hours services are performed for the QOZB within QOZs, and the denominator equaling the total number of hours services are performed for the QOZB within and without QOZs.[83]
2. *Cost of services.* This safe harbor is met if, over the course of the year, at least 50 percent of the amounts paid for services performed for the business by employees and independent contractors are for services performed within QOZs. Similar to the preceding, a ratio is used to determine if this safe harbor is met. In this case, the numerator is the amount paid by the QOZB for services performed in QOZs, and the denominator is the total amount paid by the QOZB for services performed both within and without QOZs.[84]
3. *Property and management functions.* This safe harbor is met if, over the course of the year, the QOZ-sited tangible property and management or operational functions performed within QOZs are necessary for the generation of at least 50 percent of the business's gross income.[85]

79. *Id*. § 1.1400Z2(d)-1(d)(3)(iii)(C), Example 2.
80. *Id*. § 1400Z2(d)-1(d)(2).
81. *See* I.R.C. § 1400Z02(3)(3)(A)(ii) (cross-reference to I.R.C. § 1397C(b)(2)).
82. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(i).
83. *Id*. § 1.1400Z2(d)-1(d)(3)(i)(A).
84. *Id*. § 1.1400Z2(d)-1(d)(3)(i)(B).
85. *Id*. § 1.1400Z2(d)-1(d)(3)(i)(C).

In lieu of meeting these tests, general facts and circumstances are considered.[86] However, note that in the case of rental real estate–based investments and the characteristic of non-moveable assets to the generation of income, the third safe harbor is likely to be met.

4. Intangibles Test

Where a QOZB owns intangible assets, at least 40 percent of the use of the intangibles must be in the active conduct of the QOZB's trade or business within a QOZ.[87] Intangible property is generally considered to be used in the active conduct of a trade or business in a QOZ where:

- The use of the intangible property is normal, usual or customary in the conduct of the trade or business; and
- The intangible property is used in QOZs in the performance of an activity of the trade or business that contributed to the generation of gross income for the trade or business.[88]

In the affordable housing context, this test is generally either irrelevant or easily met: Such businesses are generally real estate focused and have few intangible assets. What intangible assets affordable housing businesses do have are likely to be related to the real estate, which will need to be located in a QOZ.

5. NQFP Test

A business will not qualify as a QOZB if 5 percent or more of the average of the aggregate unadjusted bases of property owned by the business is NQFP.[89] NQFP includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in the final Treasury Regulations. Although Section 1397C(e) does not explicitly say cash and cash equivalents are NQFP, the fact that they are NQFP is commonly understood based on the reasonable working capital exclusion principals and the working capital safe harbor.

In measuring the amount of NQFP held by a QOZB, reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less is excluded from the definition of NQFP.[90] In addition, accounts or notes receivable acquired in the ordinary course of business for services rendered or from the sale of property are also excluded.

Because real estate projects require a large amount of available liquid assets during construction periods, the NQFP rules had the potential to create significant problems for such projects. Thankfully, the Regulations contain a working capital safe harbor that allows reasonable amounts of working capital to be excluded from the calculation of NQFP if the working capital is to be used within 31 months to construct/rehabilitate a building or invest in a trade or business.[91] A QOZB may benefit from more than a single overlapping or sequential application of the 31-month working capital safe harbor period, provided each

86. *Id*. § 1.1400Z2(d)-1(d)(3)(i)(D).
87. *Id*. § 1.1400Z2(d)-1(d)(3)(ii)(A).
88. *Id*. § 1.1400Z2(d)-1(d)(3)(ii)(B).
89. I.R.C. § 1400Z-2(d)(3)(A)(ii) cross-references the NQFP rules of I.R.C. § 1397C(b)(8).
90. *Id*. § 1.1400Z2(d)-1(d)(3)(iv).
91. *Id*. § 1.1400Z2(d)-1(d)(3)(v).

application satisfies all of the requirements discussed next.[92] However, the maximum time for all applications cannot exceed 62 months. Not more than an additional 24 months can also be available for a working capital safe harbor period where a QOZB is located in a federally declared disaster.[93] In the case of the COVID-19 pandemic in 2020–2021, QOZBs nationwide generally have up to an additional 24 months' use working capital assets, if they need it.[94]

For working capital amounts held by a QOZB to be treated as reasonable under the safe harbor, all of the following requirements[95] must be met:

- The amounts are designated in writing for the development of a trade or business in a QOZ, including, when appropriate, the acquisition, construction, and/or substantial improvement of tangible property in a QOZ.
- There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets that shows consumption of the working capital assets within 31 months of the date on which the business received the assets. The written designation and schedule should include provision for overlapping or sequential safe harbor periods, if such additional safe harbors are anticipated to be needed.
- The QOZB must actually use the working capital assets in a manner that is substantially consistent with the written plan and written schedule.[96]

In the case of a new OZ LIHTC project, it is typical to include the written designation and written schedule as an addendum to the partnership's limited partnership agreement.

6. Start-Up QOZB Safe Harbors

The final Treasury Regulations provide for several safe harbors, designed to allow a business to satisfy QOZB requirements through certain common business start-up issues and working capital safe harbor periods, particularly:

- Safe harbor for property on which working capital is being expended;
- Gross income safe harbor; and
- Intangible property safe harbor.

The final Treasury Regulations provide if there is a valid working capital safe harbor period in effect, the assets that are intended to be covered by the safe harbor are deemed to satisfy QOZBP requirements.[97] The QOZBP requirements directly apply to tangible property—not to the business entity—so there is a lack of consensus among practitioners as to how to interpret this rule. One interpretation of this language is that as long as the entity

---

92. *Id*. § 1.1400Z2(d)-1(d)(3)(v)(E).

93. See Notice 2021-10, which extends relief to QOZBs with working capital assets intended to be covered by the working capital safe harbor before June 30, 2021.

94. *Id.*

95. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v).

96. *Id*. § 1.1400Z2(d)-1(d)(3)(v)(A)–(C). Proposed Treasury regulations outline the permissibility, in the event of a federally declared disaster, of revised written plans and schedules, and require that such revisions must be adopted within 120 days of the end of close of a disaster period. Prop. Reg. § 1.1400Z2(d)-1(d)(3)(v)(D).

97. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi)(D)(1).

len50412_complete.indb 243 1/13/22 8:40 AM

holds working capital assets that are covered by the working capital safe harbor, then the entity is deemed to satisfy the 70 Percent Test discussed earlier.

Informal conversations with the IRS have confirmed the intent to provide this safe harbor and suspend the 70 percent tangible property standard during a valid working capital safe harbor period. This safe harbor is helpful to affordable housing businesses in particular; it provides time to purchase or construct qualified property, and time to use property in a trade or business, during which a QOZB needn't worry that these assets—not yet placed in service—are not being used in the active conduct of a trade or business.

Additionally, any gross income derived from working capital assets that are subject to a working capital safe harbor period, counts toward meeting the 50 Percent Gross Income Test.[98] During a working capital safe harbor period, a business's only income may be from interest earned on its cash deposits. This safe harbor allows a business to make the prudent business decision to deposit working capital funds into interest-bearing accounts without running afoul of the QOZB 50 Percent Gross Income Test.

Finally, intangible property (IP) purchased or licensed by a business under a valid working capital safe harbor satisfies the use requirement during any period in which the business is proceeding in a manner that is substantially consistent with its written plan. This allows a business to purchase or license the IP it may need for its business before the business is necessarily in a position to ensure that the IP's use in a trade or business is at least 40 percent conducted within QOZs.[99]

IV. AN ILLUSTRATION

Some of the concepts discussed in the preceding pages are illustrated in the following very simplified scenario: Stanley and Helen Roper are the owners of Threes Company, LLC ("Threes Co."). Threes Co. is classified as a partnership for federal tax purposes and uses a calendar year end.

Threes Co. realized $10 million of eligible gain on December 31, 2020. Threes Co. has until June 29, 2021 (180 days from December 31, 2020) to invest the gain into a QOF. If Threes Co. does not invest the gain, the Ropers have until September 11, 2021 (180 days from Threes Co.'s March 15, 2021, tax return due date without extension) to invest the gain into a QOF.

On July 15, 2021, the Ropers timely invest $10 million into a QOF organized primarily to invest in Affordable Santa Monica, LLC, a QOZB that will own and operate an affordable housing development located in a QOZ and eligible for LIHTCs. On their 2021 tax return, the Ropers elect to defer recognition of the gain on Form 8949 and report their interest in the QOF on Form 8997.

The Ropers will initially receive a $0 basis in their interests in the QOF. If the Ropers hold their QOF interests, on July 15, 2026, the Ropers will receive a basis increase equal to 10 percent of the deferred gain, or $1 million. There is not enough time before the gain realization date of December 31, 2026, for the additional 5 percent basis increase for holding the QOF investment for seven years. On their 2026 tax return, the Ropers will include gain in the amount of

98. *Id*. § 1.1400Z2(d)-1(d)(3)(vi)(B).
99. *Id*. § 1.1400Z2(d)-1(d)(3)(vi)(C).

- The lesser of the fair market value of the QOF interest[100] or the amount of gain deferred, less
- $1 million basis.

This gain will take the same character (i.e., long-term versus short-term) as the gain had at December 31, 2020. Starting July 15, 2031, and through December 31, 2047, the Ropers will be permitted to sell or dispose of their interests in the QOF and elect to have their basis in the QOF interests equal fair market value at the time of the sale or disposal.

Assuming the investment from the Ropers is the QOF's first receipt of a qualifying investment from an investor, the QOF will certify as a QOF effective July 2021. The QOF's first testing date for the sake of the 90 Percent Test will be December 31, 2021 (the last day of the first sixth-month period as a QOF). In order to provide it time to deploy recently received funds, the QOF is able to disregard the contribution from the Ropers for purposes of this first 90 Percent Test. Assuming the QOF's only assets are the cash from the Ropers (and perhaps additional subsequent investors) and interest earned on that cash, the QOF's 2021 Form 8996 will reflect 100 percent for the 90 Percent Test, with no resulting penalty.[101]

The QOF should deploy the cash from the Ropers by no later than the next testing date, June 30, 2022. On April 1, 2022, the QOF invests in newly formed Affordable Santa Monica, LLC. As an addendum to its Operating Agreement, Affordable Santa Monica, LLC adopted a written plan and schedule under which funds will be spent for the construction of the development. The written plan and schedule anticipate a second capital infusion into Affordable Santa Monica, LLC at approximately December 2024, and call for two consecutive 31-month working capital periods. This written plan should include expenditures by November 1, 2024, of amounts specified in the first 31-month period—at least equal to the amount of funds received from the QOF on April 1, 2022.

V. CONCLUSION

The Opportunity Zone incentive can pair well with affordable housing. The OZ tax benefits of delayed capital gains taxation, avoidance of 10 percent to 15 percent of capital gain tax, and tax-free appreciation are helpful to investors and developers. For OZ-LIHTC transactions in particular, OZs can also avoid exit taxes and increase the appeal of a project to investors. While there is additional complexity from including OZs, because affordable housing is real estate based, the complexity is less than it would be with other types of investments. As a result, OZ can be a positive impact on affordable housing in QOZs. However, the OZ incentive is currently structured so that no capital gains can be deferred after December 31, 2026, and thus new investments in QOF would no longer be possible. Without congressional action, new investments in QOFs can only be made for the next few years. Congress is considering extension and modification of the incentive, which would allow a longer opportunity for the incentive to impact affordable housing.

100. *See supra* note 34 and accompanying text for special rule for determining fair market value of QOF Partnership interests.

101. *See supra* note 54 and accompanying text for a discussion of the issue of $0 of QOZBP divided by $0 total assets.