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4 Working Capital Safe Harbors For QOZ Startups

By **Tucker Thoni** (August 14, 2019, 4:38 PM EDT)

Tucker Thoni

The Tax Cuts and Jobs Act[1] enacted a new tax regime aimed at incentivizing economic growth in certain gubernatorial-nominated census tracts in low-income communities[2], known as qualified opportunity zones or QOZs, by affording items of tax benefit[3] to taxpayers that make eligible investments in qualified entities, known as qualified opportunity funds, or QOFs.

This article discusses the interplay between conflicting requirements imposed by the new regime and highlights an old trap for the unwary that could result in massive penalties if a QOF real estate investment is not structured properly.

Requirements

A QOF must hold at least 90% of its assets in (a) stock or partnership interests in a qualified opportunity zone business, or QOZB, or (b) qualified opportunity zone business property.[4]

A QOZB is a subsidiary of a QOF that, in turn, owns zone property.

Zone property is tangible personal or real property satisfying the following requirements: (1) it is used in a trade or business for purposes of Internal Revenue Code Section 162,[5] (2) it was acquired after Dec. 31, 2017, by purchase from an unrelated party,[6] (3) it is substantially improved or the original use within the opportunity zone commenced with the QOF or QOZB[7] and (4) during substantially all of the QOF or QOZB's holding period (i.e., at least 90%), substantially all of the use (i.e., at least 70%) of the tangible property is in a qualified opportunity zone.[8]

Zone property can also be real or personal, leased or owned. There are specific rules applicable to qualifying leased tangible property as zone property which are beyond this article's scope.[9] This article focuses on zone property requirements (1) and (3) in the context of QOFs owning rental real property.

Substantial Improvement or Original Use

To further the congressional purpose of incentivizing investment in certain low-income and blighted areas, tangible property — other than land — must, to qualify as zone property, be substantially improved or the original use of such property within the qualified opportunity zone must commence with the QOF or QOZB.

If original use has occurred prior to acquisition, the property must be substantially improved to qualify as zone property. The previous sentence does not apply to land, which is incapable of satisfying original use, but is not required to be substantially improved to qualify as zone property. [10]

Original use occurs when the real property is placed into service for purposes of amortization or depreciation.[11] If real property has been vacant for five uninterrupted years, it can be put into service as original use property.[12] For real estate, only new construction and five-year vacant property will constitute original use property.

Real property is substantially improved when a QOF or QOZB makes improvements that double its adjusted basis in the property within 30 months of acquisition.[13] The substantial improvement requirement does not apply to land, so the entity only has to double its basis attributable to the improvements.[14]

Qualified Opportunity Zone Business Requirements

An entity must meet the following requirements and tests to qualify as a QOZB:

New Acquisition

The QOF must have obtained its interest from the entity solely in exchange for cash after Dec. 31, 2017.[15]

QOZB Purpose

The entity must be a QOZB at acquisition, or if a new entity, be organized for the purpose of being a QOZB.[16]

Regarded Entity

The entity is regarded as a corporation or partnership for federal income tax purposes.[17]

QOZB Asset Test

Substantially all — i.e., at least 70% — of the tangible property owned or leased is zone property.[18]

Gross Income Test

At least 50% of annual gross income is derived from the active conduct of a trade or business in a qualified opportunity zone.[19]

Intangible Use Test

A substantial portion — i.e., at least 40% — of the intangible property is used in the active conduct of a trade or business in a qualified opportunity zone.[20]

Nonqualified Financial Property Test

Less than 5% of the average of the aggregate unadjusted bases of entity's assets are held in "nonqualified financial property."

The term nonqualified financial property excludes reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less.[21]

Sin Business Restriction

The entity's 162 trade or business is not a sin business, which includes 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.[22]

Continuing Qualified Opportunity Zone Business Requirement

The entity must qualify as a QOZB during substantially all — i.e., at least 90% — of the QOF's holding period for the entity interest.[23]

The gross income test, intangible use test and nonqualified financial property test are material obligations imposed specifically on QOZBs.[24]

Notwithstanding these additional obligations, most taxpayers will find it advantageous to structure their investments so that a QOF owns zone property indirectly through a QOZB for two principal reasons:

First, the QOZB asset test is more lenient than the QOF asset test. When properly structured, the net effect of the QOZB asset test only requires 63% of a QOF's tangible property to be zone property and permits as much as 37% to be other tangible property.[25]

Second, the working capital safe harbors, discussed below, are only available to QOZBs.[26] The working capital safe harbors are needed to qualify most real property as zone property without penalty.

162 Trade or Business Requirement

To qualify as zone property, tangible property must be used in a 162 trade or business.[27] The QOZB asset test requires at least 70% of tangible assets to be held in zone property, which indirectly imposes the 162 trade or business requirement on QOZBs via obligatory ownership of zone property.[28]

The tax laws do not define a 162 trade or business. Indeed, former U.S. Supreme Court Justice Byron White famously lamented, in Commissioner of Internal Revenue v. Groetzinger, that despite having a "well-known and almost constant presence on our tax-law terrain" and appearing "in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations ... the Code has never contained a definition of the words 'trade or business' for general application, and no regulation has been issued expounding its meaning for all purposes."[29]

Therefore, we look to case law for guidance.

When evaluating whether enterprise activity amounts to a 162 trade or business, the U.S. Tax Court applies the following test: (1) whether a primary purpose for the activity was profit, (2) whether the taxpayer is regularly and actively involved in the activity and (3) whether the activity has actually

commenced.[30]

The first and third factors are codified by statute.[31] The second requirement, "regularly and actively," has been delineated through case law.[32] The analysis of the above factors is made at the partnership or corporate level without regard to the prior business activity of the partners or shareholders.[33]

The relevant inquiry when evaluating a 162 trade or business is whether or not the enterprise can deduct ordinary and necessary business expenses to offset gains.[34]

Whether or not the enterprise activity has commenced is the most problematic for rental real estate projects under the opportunity zone regime. The Tax Court case law finds that rental activity has not commenced while the to-be-leased property is being constructed or rehabilitated.[35] Indeed, rental activity commences when the property is offered for rent.[36]

For example, in Charlton v. Commissioner of Internal Revenue, the Tax Court disallowed business expense deductions claimed in 1994 because the taxpayers:

> incurred these expenses before the cabin rental activity became an active trade or business. Charlton renovated the cabins in 1994 but did not rent them or offer them for rent until 1998. The cabin rental activity was not an active trade or business in 1994. Thus, we conclude that the claimed expenses were nondeductible startup expenses.[37]

The Problem

A QOF incurs a penalty for each month of noncompliance with the QOF asset test, which is calculated prorata to the extent the QOF fails the QOF asset test.[38] The requirements imposed on QOZBs, including the QOZB asset test, are an all-or-nothing approach with no direct penalty for noncompliance. If the entity qualifies as a QOZB, then its value will count towards the QOF asset test.[39] Comparatively, if the entity fails to be a QOZB, then its value will not count towards the QOF asset test.[40] The dichotomy between the QOF and QOZB asset tests is a powder keg that could result in massive, monthly penalties for QOFs holding assets in improperly structured QOZBs.[41]

Zone property requires use within a 162 trade or business. Due to the required ownership of zone property, a QOZB must be 162 trade or business.[42] Rental property is not used in a 162 trade or business until it is actually being offered for rent.

Under the opportunity zone regime, real property must be newly constructed or substantially improved in order to qualify as zone property. Real estate is typically not capable of being leased during construction or substantial rehabilitation, which would seem to preclude such real property from qualifying as zone property during that time.

The QOF and QOZB asset tests generally occur on a semi-annual basis.[43] Accordingly, under the statute, the QOF or QOZB would only have about six months to complete construction or rehabilitation and commence rental activity, which is a short-runway for construction or major rehabilitation of real property.[44]

Failing the QOF or QOZB asset tests does not disallow the tax benefits associated with QOF investments; however, the penalty imposed on QOFs for noncompliance with the QOF asset test, which can be triggered in mass by failing the QOZB asset test, is draconian and would likely nullify the value of those tax benefits.

The Remedy — Working Capital Safe Harbors

There are four separate but related safe harbors that provide a grace period wherein an entity can develop a 162 trade or business without violating certain of the QOZB requirements.

All four safe harbors are contingent on the QOZB complying with the following working capital requirements:

1. The working capital assets must be designated in a written schedule, a "working capital schedule," for the development of a 162 trade or business in a qualified opportunity zone, including the acquisition, construction or substantial improvement of tangible property.[45]

2. The working capital schedule must plan for the working capital assets to be utilized within 31 months of receipt by the QOZB. The working capital schedule must be consistent with the ordinary startup of a 162 trade or business.[46]

3. The working capital assets must be actually used in a manner that is substantially consistent with the working capital schedule. The 31-months can be tolled for certain delays caused by government inaction.[47]

So long as the working capital requirements are satisfied, the safe harbors function to satisfy certain of the QOZB requirements during the 31-months, as outlined below:

Safe Harbor for Working Capital

The working capital assets are deemed to be reasonable for purposes of the nonqualified financial property test.[48]

Safe Harbor for Gross Income

Any income derived from the working capital assets is deemed to qualify under the gross income test.[49]

Safe Harbor for Use of Intangible Property

The intangible property of the QOZB is deemed to satisfy the intangible use test.[50]

Safe Harbor for Property

If the tangible property being acquired, constructed or substantially improved is expected to qualify as zone property following application of the working capital assets pursuant to the working capital schedule, then such property will not fail to be zone property solely because the working capital schedule is ongoing.[51]

The working capital safe harbors provide QOZBs relief from certain of the QOZB requirements during the startup of a 162 Trade or Business. Of significance, during the pendency of the 31-months, both the working capital assets and the property being acquired, constructed or substantially improved by the working capital assets can qualify as zone property, so long as the property is expected to qualify at the end of the 31-months.[52]

This includes the requirement that the zone property be used in a 162 trade or business, which is indirectly imposed on QOZBs by obligatory ownership of zone property.[53]

Taxpayers evaluating QOF real estate projects should ensure that the requisite construction or rehabilitation planned for the project can be completed within 31-months,[54] which is a healthy-runway to land most real property construction or rehabilitation projects.

When the safe harbors expire, the property must stand on its own as zone property, which requires use within a 162 trade or business. If the construction or rehabilitation is not complete and the property is not ready to be leased, then rental activity has not commenced and the property would not qualify as zone property until it was ready and offered for lease.

If the property is not zone property prior to the first QOF asset test following the 31-month pendency of the safe harbors, the entity will almost certainly fail to qualify as a QOZB[55], which will likely result in a heinous penalty at the QOF level.[56] The 162 trade or business requirement is an old trap for the unwary that could have devastating effects under the new qualified opportunity zone regime.

Tucker J. Thoni is a real estate and tax attorney at GrayRobinson, P.A. in Orlando, FL specializing in structuring Qualified Opportunity Zone investments, who can be reached at 407-843-8880.

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[1] 115 P.L. 97

[2] I.R.C. § 1400Z-1

[3] A discussion of the tax benefits associated with this new tax regime are beyond the scope of this article.

[4] IRC § 1400Z-2(d)(1)-(2)

[5] IRC § 162; IRC § 1400Z-2(d)(2)(D)(i); Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(A), (d)(2)(i)-(ii).

[6] IRC § 1400Z-2(d)(2)(D)(i)(I); Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(4)(i)-(ii), (d)(2)(i)(A). NOTE purchase is as defined in IRC. § 179(d)(2) and relatedness is a lower threshold — 20% — under the qualified opportunity zone regime than is normally imposed under the code — 50%. IRC § 1400Z-2(e)(2). See IRC § 267(b) and IRC § 707(b)(1).

[7] IRC. § 1400Z-2(d)(2)(D)(i)(II); Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(2)(i)(C)(4)

[8] IRC § 1400Z-2(d)(2)(D)(i)(III); Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(D), (d)(2)(i)(D).

[9] Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B), (d)(2)(i)(B).

[10] The substantial improvement and original use requirements do not apply to land. Technically, land is never improved; improvements are constructed on the land. Additionally, land is not movable and has

always been within its qualified opportunity zone, so land does not satisfy the original use requirement.

[11] Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(C), (c)(7), (d)(2)(i)(C). Original use also occurs when the property is first used in a manner that would allow depreciation or amortization if that person were the property's owner. Id.

[12] Id.

[13] Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(C), (c)(8)(i), (d)(2)(i)(C), (d)(4)(i).

[14] Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(8)(ii), (d)(4)(ii).

[15] IRC § 1400Z-2(d)(2)(B)(i)(I), (c)(i); Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(2)(i)(A), (c)(3)(i).

[16] IRC § 1400Z-2(d)(2)(B)(i)(II), (c)(ii); Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(2)(i)(B), (c)(3)(ii).

[17] Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(2)(i), (c)(3).

[18] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(1)(i), (d)(3)(i).

[19] IRC § 1397C(b)(2); Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(1)(ii), (d)(5)(i).

[20] IRC § 1397C(b)(4); Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(1)(ii), (d)(5)(ii).

[21] IRC § 1397C(b)(8), (e)(1), Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(1)(ii), (d)(5)(iii).

[22] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(1)(iii).

[23] IRC § 1400Z-2(d)(2)(B)(i)(III), (d)(2)(D)(iii); Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(2)(i)(C), (c)(3)(iii).

[24] The other QOZB requirements are similar or the same as requirements imposed on QOFs owning zone property directly.

[25] See IRC § 1400Z-2(d)(1)-(2); Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(1)(i), (d)(3)(i). The combination of the 70% QOZB asset test and the 90% QOF asset test results in a QOF having a net 63% zone property requirement — e.g., 70% times 90% equals 63%.

[26] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)-(vii).

[27] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(2)(i) (defining zone property as "tangible property used in a trade or business of an entity ... ").

[28] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(1)(i), (d)(2)(i)-(ii).

[29] Comm'r v. Groetzinger, 480 U.S. 23, 27 (1987)

[30] Dasent v. Comm'r, T.C. Memo. 2018-202; Jafarpour v. Comm'r, T.C. Memo. 2012-165, slip op. at 14(citing Comm'r v. Groetzinger, 480 U.S. 23, 35, 107 (1987); McManus v. Comm'r, T.C. Memo. 1987-457, aff'd without published opinion, 865 F.2d 255 (4th Cir. 1988); Hardy v. Comm'r, 93 T.C. 684, 687

(1989) (“Start-up or pre-opening expenses are not currently deductible under section 162 … This has been referred to as the ‘pre-opening expense doctrine.’”) (citing Sorrell v. Comm’r, 882 F.2d 484, 490 (11th Cir. 1989), revg. T.C. Memo. 1987-351).

[31] IRC § 183 (hobby-loss rules) and IRC §195 (startup or preopening expenses)

[32] See Comm’r v. Groetzinger, 480 U.S. 23, 35, 107 (1987); Richmond Television Corp. v. United States, 345 F.2d 901, 905 (4th Cir.); Jordan v. Comm'r, Summ. Op 2013-91, at *3.

[33] See Goodwin v. Comm'r, 75 T.C. 424, 434-35 (1980), aff'd, 691 F.2d 490 (3d Cir. 1982).

[34] Stanton v. Commissioner, T.C. Memo. 1967-137,aff'd, 399 F.2d 326 (5th Cir. 1968); Higgins v. Commissioner, 312 U.S. 212, 217 (1941).

[35] There is a line of cases from the U.S. Court of Claims and the U.S. Court of Appeals for the Federal Circuit finding that certain recurring business expenses may be deducted even before the business is in a position to earn income. See e.g., Blitzer v. United States, 684 F.2d 874 (Ct. Cl. 1982). That line of cases relies on older Supreme Court precedent, United States v. Gilmore, 372 U.S. 39 (1963) and Comm'r v. Tellier, 383 U.S. 687 (1966), than the Supreme Court precedent relied on by the Tax Court, Comm’r v. Groetzinger, 480 U.S. 23, 35 (1987).

The Tax Court has expressly rejected the reasoning from the Court of Claims and the Federal circuit. Johnsen v. Comm'r, 83 T.C. 103, n.5 (1984); McManus v. Comm’r, T.C. Memo. 1987-457, at *n.11; Harris v. Comm'r, 58 T.C. Memo. 1990-80, at *n.13. While the author interprets the Tax Court case law as more persuasive, the Tax Court's analysis was used for this article because it is the most common forum for tax litigation. A detailed discussion of the two lines of cases is beyond the scope of this article.

[36] Charlton v. Comm'r, 114 T.C. 333, 338 (2000); see also McPartland v. Comm'r, T.C. Summ.Op. 2012-88 (disallowing business expense deductions claimed in 2007 because the taxpayer “did not complete renovations or offer the property for rent until approximately 2009 and did not actually rent the property until 2010,” so rental real estate activity had not yet commenced.), Jordan v. Comm'r, Summ. Op 2013-91, at *3; de Sylva v. Comm'r, T.C. Memo. 2018-165, at *5.

[37] Charlton v. Comm'r, 114 T.C. 333, 338 (2000).

[38] IRC § 1400Z-2(d)(1).

[39] IRC § 1400Z-2(d)(1)-(3); Prop. Treas. Reg. § 1.1400Z-2(d)-1(c), (d).

[40] Id.

[41] A penalty is possible for QOFs holding more than 10% of their assets in any one improperly structured QOZB. The capital formation timing issues for a QOF under the regime facilitate structures where QOFs often own a single QOZB, so missing the QOZB asset test by even 1% could result in a majority, if not all, of the QOFs assets to be subject to penalty under IRC § 1400Z-2(f). The same result would occur upon a violation of any of the other QOZB Requirements.

[42] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(2)(i)-(ii).

[43] But see Prop. Treas. Reg. § 1.1400Z-2(d)-1(b)(4).

[44] IRC § 1400Z-2(f).

[45] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(A).

[46] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(B).

[47] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(C).

[48] IRC § 1397C(b)(8); Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(iv).

[49] IRC § 1397C(b)(2); Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(v).

[50] IRC § 1397C(b)(4); Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(vi).

[51] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(vii).

[52] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(vii).

[53] IRC § 1400Z-2(d)(2)(D)(i); Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(1)(i), (d)(2)(i)-(ii).

[54] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(B).

[55] The special purposes entity rules contained in most commercial real estate loan documents will necessitate single asset entities in most circumstances. While the use of "fund" implies a large, multi-asset portfolio with a pool of investors, there are no capitalization, diversification, or investor pool requirements imposed on QOFs.

[56] IRC § 1400Z-2(f).