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Opportunity Zone Regulations Update: Working Capital and Decertification Corrections

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The creation of the Qualified Opportunity Zone (QOZ) program in the 2017 Tax Reform Act has attracted more than \$15 billion of investments in 8,766 investment zones in the United States, six territories, and the District of Columbia.¹ The final QOZ regulations² included a helpful working capital safe harbor, which allows for the retention of cash, cash equivalents, and debt instruments with a term of 18 months or less as a reasonable amount of working capital for a period of up to 31 months (or possibly 62 months) if certain requirements are met.³ On August 5, 2021, the IRS issued corrections to the QOZ regulations relating to the working capital safe harbor as well as the procedures for a qualified opportunity fund (QOF) to decertify being a QOF.⁴ The working capital correction provides for clarification that the QOZ rules may be met if a “QOZ Partnership” or “QOZ Business”

initially acquire non-qualifying property (such as land purchased from a related party) and then uses working capital to construct significant improvements on that property sufficient to meet QOZ eligibility requirements.

ELIGIBLE INVESTMENTS

One of the requirements to qualify as a QOF is that the QOF invests 90% or more of its assets in a QOZ Business or a QOZ Partnership or “QOZ Corporation” that conducts the QOZ Business.⁵ QOFs usually invest in a QOZ Partnership, which owns and operates the QOZ Business and has as its primary partner a QOF.⁶ The primary eligibility requirements for a QOZ Partnership to be treated as engaged in a QOZ Business is that (1) 70% or more of its assets must be QOZ Business Property,⁷ which is a significant reduction from the 90% requirement applicable if the QOZ Fund conducted the QOZ Business itself, and (2) less than 5% of the average of the aggregate unadjusted basis of property held by the entity are held in non-qualified financial property (i.e., certain passive investment assets).⁸ The QOZ Business Property requirement and the nonqualified financial property prohibition are applied on each testing date, which is typically June 30 and December 31.

QOZ Business Property includes newly constructed or existing property purchased from an unrelated per-

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¹ Michael Novogradic, Opportunity Zones Resource Center, *Opportunity Funds Investment Report: \$15 Billion in Equity by End of 2020* (Feb. 3, 2021).

² T.D. 9889, 85 Fed. Reg. 1866 (Jan. 13, 2020).

³ Reg. §1.1400Z2(d)-1(d)(3)(v). All section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

⁴ T.D. 9889, 86 Fed. Reg. 42,715 (Aug. 5, 2021).

⁵ §1400Z-2(d)(1), §1400Z-2(d)(2).

⁶ Use of a QOZ Partnership rather than a QOZ Fund to hold the investments in a QOZ is advantageous since a QOZ Partnership can use the working capital safe harbor discussed in this article and the QOZ Partnership is only required to invest 70% of its assets in a QOZ Business Property rather than the 90% requirement applicable to a QOZ Partnership as also noted in this article.

⁷ §1400Z-2(d)(3)(A)(i); Reg. §1.1400Z2(a)-1(b)(2), §1.1400Z2(d)-1(d)(2)(i).

⁸ §1400Z-2(d)(3)(A). Nonqualified financial property includes debt, stock, partnership interests, options, future contracts, forward contracts, swaps, annuities, and similar property (excluding reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or ordinary course trade or business notes receivable). §1400Z-2(d)(3)(A).

son.⁹ When an existing property is purchased by a QOZ Partnership, the QOZ rules require the partnership to construct substantial improvements to the property over a 30-month period.¹⁰ The cost of these substantial improvements must exceed the cost of the purchased real estate (excluding, however, the cost of land). Construction of improvements is funded by equity contributed to the QOZ Partnership, the proceeds of debt financing or a combination of invested capital and borrowed funds. Absent regulatory relief, the holding of invested capital ear-marked for construction can violate the nonqualified financial property prohibition and also cause the QOZ Business Property requirement to not be met, which would jeopardize QOZ Partnership qualification.

WORKING CAPITAL SAFE HARBOR

For a QOZ Partnership, the regulations provide a 31-month working capital safe harbor for investments in QOZ Businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in a QOZ.¹¹ The regulations also provided that tangible property may benefit from an additional 31-month safe harbor period, for a maximum of 62 months, in the form of either overlapping or sequential applications of the working capital safe harbor. The 62-month safe harbor only applies if the business received multiple non-de minimis cash infusions during each 31-month safe harbor period, and the subsequent cash infusion must form an integral part of the plan covered by the first working capital safe harbor.¹²

To qualify for the working capital safe harbor, the QOZ Business or QOZ Partnership must meet the following requirements (the “Working Capital Requirements”):

1. There must be a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the QOZ;
2. There must be a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months; and
3. There must be substantially compliance with the schedule.

⁹ §1.1400Z-2(d)(2)(D).

¹⁰ Reg. §1.1400Z-2(d)(2)(D)(i)(II), Reg. §1.1400Z-2(d)(2)(D)(ii).

¹¹ Reg. §1.1400Z2(d)-1(d)(5)(v). Prop. Reg. §1.1400Z2(d)-1(d)(5)(iv); 83 Fed. Reg. 54,279, 54,284 (Oct. 29, 2018).

¹² Reg. §1.1400Z2(d)-1(d)(3)(v).

The regulations provided that holding of working capital will not cause the QOZ Business or QOZ Partnership to violate the nonqualified financial property prohibition.¹³ The regulations also included a provision that holding of working capital will be deemed to be acceptable QOZ Business Property although there was some concern as to the drafting of that provision.¹⁴

WORKING CAPITAL REGULATORY CLARIFICATION

For start-up businesses, the corrected regulations provide that if the QOZ Partnership holds working capital that meets the three Working Capital Requirements discussed above, then “the entity,” the QOZ Partnership, satisfies the QOZ Business requirements, but only during the working capital safe harbor period(s).¹⁵ While a QOZ Partnership normally must meet the 70% QOZ Business Asset requirements and not violate the nonqualified financial property prohibition in order to be engaged in a QOZ Business, those two requirements are not relevant for a start-up business during these safe harbor periods since the QOZ Partnership is treated as constituting a QOZ Business. As a result, QOZ Business status for the QOZ Partnership holding working capital may also not be jeopardized if the QOZ Partnership holds property that was acquired from a related person or was contributed to the QOZ Partnership, which is not QOZ Business Property, and thus, may cause the 70% QOZ Business Asset test to not be met.

The regulation adds that such property [the working capital] is not qualified opportunity zone business property “for any purposes,” which has an impact after the working capital safe harbor periods are over. For example, a QOZ Partnership has working capital that was intended to meet the three Working Capital Requirements and be spent within 31 months. However, due to construction delays and not governmental action, the funds are not spent in 31 months. The continued retention of that cash beyond 31 months can jeopardize compliance with the requirement that 70% or more of the assets must be held in QOZ Business Property. In addition, the holding of property that was acquired from a related person or was contributed to the QOZ Partnership, which is not QOZ Business Property, may cause failure of the QOZ Partnership to be a QOZ Business after expiration of the working capital safe harbor periods.

These corrected regulations only apply for a start-up business. The regulations did not address the treat-

¹³ Reg. §1.1400Z2(d)-1(d)(5)(iv).

¹⁴ Reg. §1.1400Z2(d)-1(d)(5)(vi)(D) (prior to correction).

¹⁵ Reg. §1.1400Z2(d)-1(d)(3)(vi)(D)(1).

ment of an existing business that seeks to take advantage of the working capital safe harbor, which retains some continuing uncertainty.

Lastly, the corrected regulations provide that any tangible property purchased, leased, or constructed with the proceeds of the working capital that would constitute QOZ Business Property is treated as QOZ Business Property during and subsequent to the working capital safe harbor periods.¹⁶ This correction did not refer to a start-up business and thus applies in all cases.

GOVERNMENTAL DELAY WORKING CAPITAL PROVISION NOT CLARIFIED

The final regulations also included a potential extension of the working capital period if there is a delay caused by waiting for governmental action.¹⁷ While the final regulations did not expand upon the requirements to take advantage of this extension, the preamble to the regulations indicated that “if a governmental permitting delay has caused the delay of a project covered by the 31-month [safe harbor], and no other action could be taken to improve the tangible property or complete the project during the permitting process, then the 31-month [safe harbor] will be tolled for a duration equal to the permitting delay.”¹⁸ The corrected regulations did not incorporate this preamble language or other clarification into the regulations.

CERTIFICATION & DECERTIFICATION

The final regulations contained rules for self-certification of a QOF and added a provision allowing a QOF to voluntarily de-certify its QOF status. Self-certification as a QOF is done by filing Form 8996, *Qualified Opportunity Fund*, and attaching the form to a timely filed federal income tax return (taking into account extensions) for the taxable year.¹⁹ The regulations allow a QOF to voluntarily decertify in the

¹⁶ Reg. §1.1400Z2(d)-1(d)(3)(vi)(D)(2).

¹⁷ Reg. §1.1400Z2(d)-1(d)(3)(v)(C).

¹⁸ T.D. 9889, 85 Fed. Reg. 1866, 1926 (Jan. 13, 2020).

¹⁹ Reg. §1.1400Z2(d)-1(a)(2)(i).

form and manner prescribed by the IRS in forms or instructions.²⁰

The final regulations had contained a timing rule, which provided that self-decertification was effective at the beginning of the month following the month that the QOF specified, and the QOF could not specify a month earlier than the month in which the taxpayer filed its self-decertification.²¹ This timing rule was removed in the correcting amendments, which leaves the timing rules to be set forth in supplemental guidance.

Apart from the foregoing, the final regulations did not contain rules for involuntary decertification or address whether repeated failures to satisfy the 90% test will lead to a revocation of QOF status. The Preamble notes that the IRS and Treasury continue to consider the circumstances under which involuntary decertification of a QOF would be warranted. The corrected regulation did not address involuntary decertification.²²

CONCLUSION

The QOZ statutory provision contained numerous areas of uncertainty, which the IRS has attempted to address in its comprehensive set of applicable regulations. These recent corrections to the working capital regulations illustrates that the IRS is listening to concerns raised about the working capital safe harbors although further clarification for other than start-up businesses may be needed. However, the elimination of the timing rule for decertification raises a new area of uncertainty. In light of proposals to raise capital gains tax rates, some QOFs may want to consider decertification if they can avoid deferred capital gains from being taxed at higher rates. As a result, guidance on timing of self-decertification as well as the applicable procedures would be helpful.

²⁰ Reg. §1.1400Z2(d)-1(a)(3).

²¹ Reg. §1.1400Z2(d)-1(a)(3)(ii) (removed by August 2021 correction).

²² An example in the final regulations provided that the general anti-abuse rule would apply to disallow the tax benefits under the QOZ program where a QOF repeatedly fails the 90% test and never intended to qualify as a QOF. Reg. §1.1400Z2(f)-1(c)(3)(vi).