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Good Enough: How Minimal IRS Guidance is Sufficient to Navigate §1400Z Opportunity Zones

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Good Enough: How Minimal IRS Guidance is Sufficient to Navigate § 1400Z Opportunity Zones

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ABSTRACT

Subchapter Z, as part of the Tax Cuts and Jobs Act, creates "Opportunity Zones" which provide investors with a tax incentive to invest their realized capital gains in certain distressed neighborhoods. The goal of this subchapter is the economic growth of these communities. As described below, the language of subchapter Z is subject to interpretation in certain respects. Subsequently, the IRS issued a proposed regulation to provide guidance and clarity to the ambiguities within the language. Although many issues still remain unresolved, the guidance provided is a significant step in the right direction.

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I. INTRODUCTION

Loud noises surround you as you sit at the Bellagio-embossed blackjack table and are dealt an eight of hearts and an eight of diamonds. The dealer flips over an ace and a six—also known as a "soft 16." You are asked whether to hit, stay, double down, or split. You timidly say "hit" before receiving a queen of spades. The dealer informs you that you have "busted," and your chips are quickly whisked off the table.

Similar to a Las Vegas card game, investing can seem like a gamble. For blackjack players, it is reasonable to assume that you would be informed of the rules before you begin playing. This guidance would help you understand each person's role at the table, the meanings of the cards, and how best to play in order to increase the odds of succeeding. Likewise, an investor hopes for the same type of guidance before making an investment. An investor may not expect a guaranteed return, but he needs to know the ground rules before he makes his investment. Without this guidance, an investor may choose to forgo the opportunity because the game is too unknown.

This article will analyze subsection §1400Z of the Tax Cuts and Jobs Act. Part II provides a background of the subsection. Part III examines the language of the subsection, and Part IV summarizes the guidance the Internal Revenue Service ("IRS") has provided. Part V sets forth the unresolved issues with § 1400Z. Finally, Part VI closes this article by concluding that the IRS has provided sufficient guidance to give individuals enough confidence to invest. While some issues still remain unresolved, the guidance already published is a significant step in the right direction.

II. BACKGROUND

The Tax Cuts and Jobs Act of 2017 ("TCJA") was signed into law on December 22, 2017.[1] The TCJA made significant modifications to the tax code—a reduction of tax rates for businesses and individuals, an increased standard deduction, a limitation on state deductions and property taxes, a reduction of the estate tax, a repeal of the individual mandate of the Affordable Care Act, and a number of other changes.[2] One particularly interesting section within the TCJA is a new provision: Subchapter Z "Opportunity Zones."[3]

Subchapter Z created 8,700 "Opportunity Zones" which are economically-distressed communities designated by the state and certified by the Secretary of the U.S. Treasury.[4] The vast majority of these zones are areas with low average income,

1. Bruce Miller, *A Summary of Tax Law Changes*, SEEKING ALPHA (Mar. 21, 2018, 2:42 PM), https://seekingalpha.com/article/4158100-summary-tax-law-changes.

2. *Id.*

3. I.R.C. § 1400Z (2018).

4. I.R.S. Notice 2018-48, 2018-28 I.R.B. 9 (July 9, 2018). James Edward Maule, *The Eagerly Awaited Opportunity Zone Regulations: What Do They Tell Us and What Do We Still Need to Figure Out?* 2 (Bureau of Nat'l Affairs, Portfolio 597-2nd: Tax Incentives for Economically Distressed Areas, Working Papers Worksheet No. 1, 2018) (stating that to become a qualified opportunity zone ("QOZ"), the "population census tract" must meet "the definition of a 'low income community'" as defined in § 45D(e) "in the context of the New Markets Tax Credit" and be "specifically designated as a" QOZ under §1400Z-1). The official list of all zones is contained within I.R.S. Notice 2018-48, 2018-28 I.R.B. 9.

and each state is limited to designating 25% of their state as opportunity zones.[5] The purpose of this new subchapter is "to encourage economic growth and investment in designated distressed communities."[6]

III. THE RULE

Subchapter Z of the Internal Revenue Code includes two subsections: § 1400Z-1, which "provides procedural rules for designating qualified opportunity zones and related definitions," and § 1400Z-2, which provides certain tax benefits to investors.[7] States have previously designated these zones,[8] so the focus is on § 1400Z-2: "Special Rules for Capital Gains Invested in Opportunity Zones."[9]

The tax incentive created by Subchapter Z is best described by example. Suppose you recently realized a $200,000 profit[10] in the stock market. You invest this amount into a particular fund which invests in certain property within a distressed zone.[11] Subchapter Z allows you to defer the tax you owe on your $200,000 until the end of 2026.[12] Further, if you hold this investment for seven years, you can exclude 15% of that $200,000 profit from your taxable income.[13] If you hold the investment for ten years, you can completely exclude any post-investment appreciation.[14]

Subchapter Z's purpose is to increase economic growth and investment in distressed communities through federal income tax benefits to investors.[15] The particular fund that taxpayers invest into is known as a "Qualified Opportunity Fund"

5. Dickinson Wright, *Treasury Releases Proposed Regulations on Opportunity Zones*, JDSUPRA (Oct. 25, 2018), https://www.jdsupra.com/legalnews/treasury-releases-proposed-regulations-78053/.

6. Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54279-01, 54281 (Oct. 29, 2018).

7. *Id.* at 54279.

8. I.R.S. Notice 2018-48, 2018-28 I.R.B. 9.

9. I.R.C. § 1400Z-2 (2017).

10. I.R.C. § 1222 (2014) (this profit is considered a "capital gain." Capital gain is defined by the Internal Revenue Code as "gain from the sale or exchange of a capital asset."). *See* I.R.C. § 1221(a) (2017) (a capital asset is "property held by [a] taxpayer" unless it is an exception listed in § 1221(a). The exceptions listed in § 1221(a) include: (1) depreciable personal property and real property used in trade or business, (2) certain creative works, (3) accounts or notes receivable, (4) publications of the U.S. government received for free, (5) supplies, and (6) inventory, which is property held for sale to customers. One common capital gain incurred by taxpayers is the rise in the value of a stock or real estate investment that makes it worth more than the amount the taxpayer initially paid. Tax must be paid upon this value increase after a taxable event occurs, such as selling the asset.).

11. *See* I.R.C. § 1400Z-2.

12. I.R.C. § 1400Z-2(b)(1) (the year the capital gain must be included in income ("year of inclusion") shall be "the earlier of (A) the date on which such investment is sold or exchanged, or (B) December 31, 2026.").

13. I.R.C. § 1400Z-2(b)(2) (under this subsection, the amount of gain included in gross income shall be the excess of "(i) the lesser of the amount of gain excluded under paragraph (1) or the fair market value of the investment as determined as of the date described in paragraph (1), over (ii) the taxpayer's basis in the investment." The basis in the investment is determined under § 1400Z-2(b)(2)(B).).

14. I.R.C. § 1400Z-2(c) (the rule states specifically, "[i]n the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under this clause, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged.").

15. Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54279-01, 54296 (Oct. 29, 2018).

("QOF").[16] A QOF is an investment vehicle organized as a corporation or partnership[17] set up for investing in eligible property that is located within an opportunity zone.[18] Although there are numerous exceptions,[19] in general, a QOF can invest in any business within the designated zone, other than a golf course, country club, massage parlor, liquor store, suntan facility, hot tub facility, or gambling facility.[20] This business is one "in which substantially all of the tangible[21] property owned or leased by the taxpayer is qualified opportunity zone business property."[22] A QOF must hold at least 90% of its assets in qualified opportunity zone property.[23] This property can be (a) qualified opportunity zone stock, (b) qualified opportunity zone partnership interest, or (c) qualified opportunity zone business property ("QOZBP").[24]

In short, the IRS now allows for "temporary deferral of inclusion in gross income for capital gains reinvested in a [QOF] and the permanent exclusion of [certain] capital gains from the sale or exchange of an investment in the [QOF]."[25] Investors can also significantly increase their basis on current investments if it is held for a certain period of time.[26] An analysis of the code section itself may prove useful.

> (a) In general.
>
> (1) Treatment of gains. In the case of gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer, at the election of the taxpayer—

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16. I.R.C. § 1400Z-2(d)(1).
17. *Id.* (the rule does not provide whether a QOF may be a S corporation, Limited Liability Company ("LLC"), or other entity). For discussion on the proposed regulations published by the IRS and the Treasury Department clarifying this language, *see infra* Part IV.
18. I.R.C. § 1400Z-2(d)(1).
19. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54279-01.
20. *Id.* at 54296 (The proposed regulations state specifically:

Trade or businesses described in section 144(c)(6)(B) not eligible. Pursuant to section 1400Z-2(d)(3)(A)(iii), the following trades or businesses described in section 144(c)(6)(B) cannot qualify as a qualified opportunity zone business:
(i) Any private or commercial golf course,
(ii) Country club,
(iii) Massage parlor,
(iv) Hot tub facility,
(v) Suntan facility,
(vi) Racetrack or other facility used for gambling, or
(vii) Any store the principal business of which is the sale of alcoholic beverages for consumption off premises.).

21. Tangible property is not "tangible personal property" as defined in I.R.C. § 48 (2018). Rather, "tangible property" as used in Subchapter Z means "tangible business property, which includes both real property and other tangible property used in a business operating in an opportunity zone." Investing in Qualified Opportunity Fund, 83 Fed. Reg. at 54284.
22. I.R.C. § 1400Z-2(d)(3)(A)(i) (this business must also satisfy "the requirements of paragraphs (2), (4), and (8) of [§] 1397C(b), and which is not described in [§] 144(c)(6)(B)).
23. *Id.* § 1400Z-2(d)(1) (this is "determined by the average of the percentage of qualified opportunity zone property held in the fund as measured–(A) on the last day of the first 6-month period of the taxable year of the fund, and (B) on the last day of the taxable year of the fund.").
24. *Id.* § 1400Z-2(d)(2)(A).
25. THOMSON REUTERS, COMPLETE ANALYSIS OF THE TAX CUTS AND JOBS ACT ¶ 1 (2017).
26. I.R.C. § 1400Z-2(b)(2)(B).

(A) gross income for the taxable year shall not include so much of such gain as does not exceed the aggregate amount invested by the taxpayer in a qualified opportunity fund during the 180-day period beginning on the date of such sale or exchange,

(B) the amount of gain excluded by subparagraph (A) shall be included in gross income as provided by subsection (b), and

(C) subsection (c) shall apply.[27]

This portion of § 1400Z-2 pertains to the tax incentive available to the taxpayer for investing in a qualified opportunity fund.[28] Further, it limits which type of gains can be used. The rule provides that gains must be reinvested in a QOF within 180 days of the sale of the capital asset to be eligible.[29]

(b) Deferral of gain invested in opportunity zone property.

(1) Year of inclusion. Gain to which subsection (a)(1)(B) applies shall be included in income in the taxable year which includes the earlier of—

(A) the date on which such investment is sold or exchanged, or

(B) December 31, 2026.[30]

Section 1400Z-2(b)(2) is the main tax benefit provided to the taxpayer through this section.

(2) Amount includible.

(A) In general. The amount of gain included in gross income under subsection (a)(1)(A) shall be the excess of—

(i) the lesser of the amount of gain excluded under paragraph (1) or the fair market value of the investment as determined as of the date described in paragraph (1), over

(ii) the taxpayer's basis in the investment.[31]

Section (b)(2) states that some gain will be included in gross income, but only the excess of (1) "the lesser of the amount of gain" or the FMV of the investment over (2) their basis.[32]

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27. I.R.C. § 1400Z-2(a).
28. *See id.* § 1400Z-2.
29. *Id.* § 1400Z-2(a)(1)(A).
30. *Id.* § 1400Z-2(b).
31. *Id.* § 1400Z-2(b)(2).
32. *Id.*

Sections 1400Z-2(b)(2)(B) and (c) allow investors to increase their basis in the investment depending on how long the property is held.[33] If the property is held for at least five years, the basis may be increased by 10% of the amount of the gain deferred.[34] If the property is held for at least seven years, then the basis may be increased by 15% of the amount of the gain deferred.[35] Finally, if the property is held for ten years or longer, the basis may be increased to the fair market value of the property.[36]

Section (d) provides definitions and requirements surrounding the QOF, qualified property, stock, interests, and QOZBP.[37] Section 1400Z-2(d)(2)(D) provides that the "original use" of QOZBP "commences with the [QOF] or the [QOF] substantially improves the property, and during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone."[38] Section (d) does not provide a definition of "substantially all," which will be further discussed in Part IV of this article.[39]

Section 1400Z-2(e) outlines restrictions on investments involving mixed funds and the treatment of decedents.[40] This section further provides that additional regulations may be provided "to prevent abuse" or ensure QOFs have "a reasonable period of time for reinvestment" with regards to proceeds of holding QOF interests.[41]

Section 1400Z-2(f) outlines the penalty for failure of a QOF to maintain the 90% rule.[42] "If a QOF fails to meet the 90%" rule, the QOF shall pay a penalty for each month it fails in an amount equal to the "excess of [(i)] the amount equal to 90% of its aggregate assets over [(ii)] the aggregate amount of" qualified opportunity zone property held by the fund multiplied by the underpayment rate stated in 26 U.S.C. § 6621(a)(2).[43]

Subchapter Z provided a guideline for the tax benefits taxpayers could expect if they choose to invest in a QOF.[44] Yet, the rule lacked clarity on numerous issues, leaving investors with uncertainty. In an effort to resolve this, individuals requested more information.[45] The next part of this article will analyze how the IRS responded

33. *Id.* § 1400Z-2(b)(2)(B), (c).
34. *Id.* § 1400Z-2(b)(2)(B)(iii).
35. *Id.* § 1400Z-2(b)(2)(B)(iv).
36. *Id.* § 1400Z-2(c).
37. *Id.* § 1400Z-2(d).
38. *Id.* § 1400Z-2(d)(2)(D)(i)(II)-(III).
39. *Id.*; *see infra* Part IV.
40. I.R.C. §1400Z-2(e).
41. *Id.* § 1400Z-2(e)(4).
42. *Id.* § 1400Z-2(f).
43. Maule, *supra* note 4, at 10.
44. *Id.*; *see* I.R.C. § 1400Z-2(d).
45. Raj Bandla, *IRS and Treasury Department Release Opportunity Zones Guidance*, JDSUPRA (Oct. 25, 2018), https://www.jdsupra.com/legalnews/irs-and-treasury-department-release-48880/ (stating specifically, "investors and developers alike have been hesitant to take advantage of the program due to numerous technical questions about how the program would be implemented."). Letter from Forrest David Milder, Former Chair of the ABA Forum & Member of the Tax Credit Comm., B. Susan Wilson, Co-chair of the Tax Credit Comm., & Glenn A. Graff, Member of the Governing Comm. of the ABA Forum & former Co-chair & current Member of the Tax Credit Comm., to Michael Novey, U.S. Dep't of the Treasury (July 3, 2018), https://www.taxnotes.com/tax-notes-today/tax-preference-items-and-incentives/individuals-identify-opportunity-zone-issues-needing-guidance/2018/07/17/287q4.

to investors' requests for guidance. While it does not provide an answer to every question, it does clear up most of the confusion.

IV. IRS GUIDANCE

After passage of § 1400Z, a number of individuals and organizations were left seeking guidance from the IRS on elements of the section.[46] Investors, local planners, non-profit organizations, housing groups, and mayors formally requested guidance on this subchapter.[47] The IRS listed it as number 14 on the "Office of Tax Policy and IRS 2017-2018 Priority Guidance Plan," meaning the IRS took notice that guidance was requested.[48]

Investors were particularly interested in whether they could defer taxes on all gains, including short term and long-term capital gains, § 1231 gains, and ordinary gains.[49] Subchapter Z simply stated "gains" but failed to specify the exact types permitted.[50] Further, investors requested that the Treasury define the term "substantially all" as it applies to the section requirement that a business's property must be opportunity zone business property for a fund to qualify for tax benefits.[51] Investors also requested guidance on which taxpayer must make the investment and when it must be made.[52]

Finally, on October 19, 2018, the IRS issued much anticipated proposed regulations[53] with a contemporaneous revenue ruling.[54] The proposed regulations "address[ed] the type of gains that may be deferred by investors, the time by which corresponding amounts must be invested in QOFs, and the manner in which investors may elect to defer specified gains."[55] It also provided guidance relating to "rules for self-certification, valuation of QOF assets, and guidance on qualified opportunity zone businesses."[56] The Revenue Ruling addressed the "application to real property of the 'original use' requirement contained in [§] 1400Z-2(d)(2)(D)(i)(II) and the 'substantial improvement' requirement in [§] 1400Z-2(d)(2)(D)(i)(II) and 1400Z-2(d)(2)(D)(ii)."[57] The proposed regulations also stated that "the basis attribut[ion] to land on which such a [purchased] building sits is not taken into account in determining whether the building has been 'substantially improved.'"[58] Next, an in-depth analysis of the pertinent portions of the IRS's proposed regulations will be provided. This analysis will show specifically which areas of § 1400Z were clarified by the IRS guidance.

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46. *See* Bandla, *supra* note 45; *see also* Milder, Wilson & Graff, *supra* note 45.
47. *See* Bandla, *supra* note 45; *see also* Milder, Wilson & Graff, *supra* note 45.
48. *See* DEP'T OF THE TREASURY, IRS, 2017-2018 PRIORITY GUIDANCE PLAN 13 (Oct. 20, 2017), https://www.irs.gov/pub/irs-utl/2017-2018_pgp_initial.pdf.
49. Milder, Wilson & Graff, *supra* note 45 (stating "[t]he title of Section 1400Z-2 refers to 'capital gains,' but the actual statute only refers to 'gains'"). *See* I.R.C. § 1400Z-2.
50. Milder, Wilson & Graff, *supra* note 45.
51. *Id.*
52. *Id.*
53. Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54279-01 (Oct. 29, 2018).
54. I.R.S. Notice 2018-29, 2018-45 I.R.B. 765 (Nov. 5, 2018); Maule, *supra* note 4, at 4.
55. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54279.
56. *Id.*
57. *Id.*
58. *Id.*

A. Deferring Tax on Capital Gains by Investing in Opportunity Zones

Although the statutory text is silent as to whether Congress intended both ordinary gains and capital gains to qualify for deferral eligibility under § 1400Z-2, "the legislative history explicitly identifies 'capital gains' as the gains that are eligible."[59] "The Treasury Department and the IRS believe . . . that [§] 1400Z-2 is best interpreted as making deferral available only for capital gains."[60] Investors would have greater flexibility if other types of gains beyond capital gains were applicable, but the IRS guidance provides them with certainty on this issue.[61]

The deferred gain "must be gain that would be recognized, if deferral under [this section] were not permitted, not later than December 31, 2026, [and] the gain must not arise from a sale or exchange with a related person as defined in § 1400Z-2(e)(2)."[62]

B. Permitted Taxpayer and Interest Type

The proposed regulations provided that the taxpayers eligible to defer gain are those that recognize capital gain for federal income tax purposes including "individuals, C corporations [RICs and REITs], partnerships, and certain other pass-through entities, . . . qualified settlement funds" and "S corporations, decedents' estates, and trusts."[63] This means that not only may individual taxpayers invest, but entities and companies may as well.[64] Any investment in a QOF is limited to equity interest, including preferred stock or a partnership interest, but it cannot be a debt instrument.[65] Generally, this means that investors may not defer any capital gains that are used to provide a loan to the QOF; investors may only defer gains invested as equity.[66]

C. Deferring Gain by Investing in a QOF

As stated in Part III above, a taxpayer has 180 days from the sale of his or her capital asset to invest in a QOF if they seek to defer their capital gain.[67] One issue with the 180-day rule, as written in § 1400Z-2(a)(1)(A), is that some capital gains do not have a specific sale or exchange date.[68] The proposed regulations solve this issue by stating that "the first day of the 180-day period [will be] the date on which

59. *Id.* at 54280.
60. *Id.*
61. Maule, *supra* note 4, at 5, 9.
62. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54280.
63. *Id.* at 54282. Those entities eligible to defer gain also include "disputed ownership funds and other entities taxable under § 1.468B of the Income Tax Regulations." *Id.* at 54280.
64. *Id.*
65. *Id.*
66. *Id.*
67. I.R.C. § 1400Z-2(a)(1)(A) (2017) (stating "gross income for the taxable year shall not include so much of such gain as does not exceed the aggregate amount invested by the taxpayer in a qualified opportunity fund during the 180-day period beginning on the date of such sale or exchange.").
68. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54280 (this can occur when, as a result of Federal tax rules, an amount is deemed to be a gain from sale or exchange of a capital asset, thus it does not have a sale or exchange date.).

the gain would be recognized for federal tax purposes, without regard to the deferral possible under [§] 1400Z-2."[69]

One question raised prior to the IRS guidance is whether a taxpayer is allowed to re-invest previously-invested deferred gain. More specifically, this issue concerns whether a taxpayer who sells or exchanges an interest in a QOF prior to December 31, 2026 will be able to re-invest into a new investment in a QOF and again defer his gain. The proposed regulations say "yes," so long as (1) the investor "make[s] the new investment in a QOF within 180 days of the date that the investor would otherwise have been required to include the previously deferred gain in income and (2) the investor . . . disposed of the entire initial investment."[70] Comments are requested to help determine "whether the final regulations should [provide] exceptions to the general 180-day rule."[71]

The proposed regulations provide that if a taxpayer invests in a QOF and later "disposes of less than all of its fungible interests in a QOF," those interests being disposed "must be identified using a first-in, first-out (FIFO) method."[72] When the FIFO method cannot be used—"such as [when] gains with different attributes are invested in indistinguishable interests at the same time"—"the pro rata method [shall] be used to determine the character, and any other attributes, of the gain."[73]

D. Capital Gain From § 1256 Contracts

A question arose regarding how capital gain from a "Section 1256 Contract" would be treated. A § 1256 contract is a particular type of investment defined by the IRS "as a regulated futures contract, foreign currency contract, non-equity option, dealer equity option, or dealer securities futures contract."[74] A taxpayer is only allowed to defer "the capital gain net income from [a] § 1256 contract[] for a given taxable year," making it only available "on an aggregate basis."[75] The deferral is unavailable if the contract was part of an "offsetting-positions transaction"[76] in which any of the other positions was not also a § 1256 contract, such as investors holding a "straddle" position.[77] Moreover, "the 180-day period for investing capital gain net income from [§] 1256 contracts invested in a QOF begins on the last day of the taxable year."[78] Although investors would receive a greater tax benefit if capital gain from § 1256 contracts were eligible for deferral, at least the proposed regulations provide certainty on this issue.

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69. *Id.* at 54280–81.
70. Maule, *supra* note 4, at 7.
71. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54281
72. *Id.*
73. *Id.*
74. Julia Kagan, *Section 1256 Contract*, INVESTOPEDIA, https://www.investopedia.com/terms/s/section-1256-contract.asp (last updated July 19, 2010).
75. Maule, *supra* note 4, at 4.
76. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54282.
77. Maule, *supra* note 4, at 5 (stating "The Treasury Department and the IRS considered allowing deferral under [§] 1400Z-2(a)(1) for a net amount of capital gain related to a straddle (as defined in [§] 1092(c)(1)) after the disposition of all positions in the straddle. However, *such a rule would pose significant administrative challenges*.") (emphasis added).
78. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54281.

E. Pass-Through Entities[79]

One highly sought-after piece of guidance surrounds the treatment of capital gains invested through a pass-through entity.[80] The proposed regulations state eligible capital gains from a sale or exchange of an asset by a partnership (or other pass-through entity) can be elected to be deferred by either the partnership or by a partner.[81] Thus, a partner can "elect to defer all or part of the gain [] to the extent that the partnership does not so elect."[82] This rule provides "significant flexibility with respect to the timing of an investment of deferred gain in a QOF."[83]

F. Termination Date

The Qualified Opportunity Zone ("QOZ") "designation" ends on December 31, 2028, and investors wonder whether this forces them to invest immediately or whether an investment made in 2019 or later and held for ten years satisfies the rule.[84] The proposed regulations state that the expiration of the zone at the end of 2028 does not prohibit investors from receiving tax benefits for investments made in 2019 or later, so long as the investment is made before June 28, 2027.[85]

G. "Substantially All" Requirement

Section 1400Z-2 states several requirements referencing the term "substantially all" or "substantially improved."[86] The proposed regulations stated that "substantially all" is equivalent to at least 70%, at least in one section of the rule.[87] This means that "[i]f at least 70[%] of the tangible property owned or leased by a trade or business is [QOZBP] (as defined [in §] 1400Z-2(d)(3)(A)(i)), the trade or business is treated as satisfying the substantially all requirement in [§] 1400Z-2(d)(3)(A)(i)."[88] If the tangible property is a building that is not being demolished, then it must be "substantially improved," as measured by the basis of the building and not the underlying land.[89] The IRS guidance in Revenue Ruling 2018-29 clarifies § 1400Z-2(d)(2)(D)(ii), providing that tangible property used in the trade or business of a QOF will be considered to be substantially improved only if an addition to basis occurs to exceed the adjusted basis of such tangible property.[90] Essentially, the value of the physical property at purchase must be doubled to constitute

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79. Julia Kagan, *Flow-Through Entity*, INVESTOPEDIA, https://www.investopedia.com/terms/f/flow-through.asp (last updated May 8, 2018) (a "pass-through entity" is a type of business entity "that passes income to the owners and/or investors . . . . Only the investors or owners are taxed on [profit generated,] not the [business] entity itself.").
80. Milder, Wilson & Graff, *supra* note 45. *See, e.g.*, Maule, *supra* note 4.
81. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54280, 54282.
82. *Id.* at 54282, 54292.
83. Maule, *supra* note 4, at 5.
84. *Id.* at 8.
85. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54283.
86. *See* I.R.C. § 1400Z-2(d)(2)(B)-(D), (d)(3)(A)(i) (2017).
87. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54285.
88. *Id.*
89. *Id.* at 54294.
90. I.R.C. § 1400Z-2(d)(2)(D)(ii); I.R.S. Notice 2018-29, 2018-45 I.R.B. 765 (Nov. 5, 2018) ([T]angible property used in a QOF's trade or business is treated as substantially improved by the QOF only

substantial improvement.[91] The same rule applies to a building located on land within a QOZ, except that the cost of land where the building sits is not included in the taxpayer's adjusted basis.[92] However, the land need not be separately substantially improved for such land to qualify as QOZBP.[93] This brings certainty to taxpayers when evaluating investment opportunities as to whether this requirement would be met. It also provides a significant opportunity for real estate investors because only the value of the building must be doubled to constitute significant improvement.[94]

H. "Original Use" Requirement

As stated in Part III above, Subchapter Z includes a requirement that for property to be QOZBP, the original use of such property must "commence" with the QOF or the QOF must substantially improve such property.[95] Revenue Ruling 2018-29 helped clarify the uncertainty surrounding this requirement.[96] The IRS held that "[i]f a QOF purchases an existing building located on land that is wholly within a QOZ, the original use of the building in the QOZ is not considered to have commenced with the QOF," and "the original use of tangible property in the QOZ commenced with a QOF is not applicable to the land."[97] In essence, the original use requirement mandates a QOF to either (1) purchase property that does not have existing buildings, therefore new property built would be "commencing" with the QOF, or (2) if property with an existing building is purchased, substantially improve the property.

I. Definitions

The proposed regulations clarify that the term "qualified opportunity zone property" includes "qualified opportunity zone business property" within § 1400Z-2(d)(2)(A).[98] Section 1400Z-2 requires that a QOF hold at least 90% of its assets as a QOZBP.[99] The definition is critical to ensure compliance with the rule. QOZBP is "tangible property used in a trade or business" that was acquired by purchase after December 31, 2017 and either (a) "the original use of [the] property in the . . . zone commences with the" QOF (or the qualified opportunity zone business ("QOZB")), or (b) the QOF (or QOZB) substantially improves the property and "substantially

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if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to basis with respect to such tangible property in the hands of the QOF exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the QOF.).

91. Maule, *supra* note 4, at 12 (stating "this has been his has been referred to as 'doubling down' because basis needs to be doubled.").
92. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54279.
93. *Id.* at 54294; I.R.S. Notice 2018-29, 2018-45 I.R.B. 765.
94. Maule, *supra* note 4, at 12.
95. I.R.C. § 1400Z-2(d)(2)(D)(i)(II)-(III).
96. *See* I.R.S. Notice 2018-29, 2018-45 I.R.B. 765.
97. *Id.*
98. Investing in Qualified Funds, 83 Fed. Reg. 54279-01, 54284 (Oct. 29, 2018).
99. *Id.*

all" of the use of the property is in the zone, during substantially all of the fund's holding period.[100]

For an entity to qualify as a QOZB, "the entity must be a [QOZB] both (a) when the QOF [takes] its equity interest in the entity and (b) during substantially all of the QOF's holding period for that interest."[101] Further, this entity must "be one in which substantially all of the tangible property owned or leased by the taxpayer is [QOZBP]."[102]

V. Unresolved Issues

Even with some guidance about the rules of blackjack, some people may still feel uncertain of how to play and choose to sit out. But, an investor becomes *more* confident and *more* willing to participate once the ground rules are clarified and fewer issues remain unresolved. QOF investors have remaining questions even after the IRS issued guidance.[103] Some of these questions focus on the definition of QOZBP, the tax consequences of the sale of an asset by a QOF, the applicable QOF penalties, and the issues surround the exit of investors from a fund.[104]

A. Reasonable Cause Exception of 1400Z-2(f)

Section 1400Z-2(f) provides that a QOF that fails to meet the QOZBP requirement shall pay a penalty, except when "such failure is due to reasonable cause."[105] No guidance has been provided to clarify or define "reasonable cause."[106] The IRS may use a similar interpretation as the reasonable cause exception in the Real Estate Investment Trust ("REIT") context.[107] In this context, reasonable cause occurs when the REIT "exercise[d] ordinary business care and prudence" in its attempt to satisfy the tests.[108] Generally, relying on a tax opinion rendered by a tax advisor is sufficient to constitute "reasonable cause."[109] It is still unknown whether the same definition will be used in § 1400Z-2. The Treasury Department and the IRS plan to address this in forthcoming proposed regulations.[110]

100. I.R.C. § 1400Z-2 (d)(2)(D)(i).
101. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54285.
102. *Id.*
103. Maule, *supra* note 4, at 1.
104. *Id.*
105. I.R.C. § 1400Z-2(f).
106. Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54279-01.
107. Maule, *supra* note 4, at 18.
108. Treas. Reg. § 1.856-7(c)(2)(ii) (as amended in 1984).
109. *Id.* § 1.856-7(c)(2)(i).
110. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54280 (stating specifically, "[t]he forthcoming proposed regulations are expected to address other issues [including] . . . administrative rules applicable under section 1400Z-2(f) when a QOF fails to maintain the required 90[%] investment standard.").

B. Definition of "Reasonable Period"

The term "reasonable period" is defined neither in § 1400Z nor the published guidance.[111] This issue has been known since the creation of § 1400Z, as it was specifically mentioned in the rule itself.[112] Section 1400Z-2(4) states, "[t]he Secretary shall prescribe such regulations as may be necessary . . . to ensure a qualified opportunity fund has a reasonable period of time to reinvest the return of capital."[113] Without this guidance, QOF managers are uncertain of the time period allotted for reinvestment of "the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and . . . proceeds received from the sale or disposition of qualified opportunity zone property."[114] The manager directing the QOF risks receiving a penalty if proceeds are not reinvested immediately.[115] The IRS may decide to follow a similar 180-day period mandated in § 1400Z-2(a)(1)(A) for gain to be invested in a QOF.[116] Looking to other sections for guidance, the IRS may provide that the taxpayer must nominate potential reinvestments within a set period similar to the requirements for like-kind exchanges in § 1031.[117] In this section, investors have 45 days to nominate potential replacement properties and 180 days to acquire the replacement property in order to defer capital gains taxes from the sale of "like-kind" property.[118]

C. "Original Use" Definition

Section 1400Z-2(d)(2)(D) provides use of QOZBP must be the "original use of such property in the" QOZ within the QOF or the QOF "substantially improves the property."[119] Although the revenue ruling addressed the application of "original use," it failed to explain "how the original use and substantial improvement tests apply to a purchase of land" or a purchase of land "with a building to be demolished."[120] Specifically in these cases, the land will not meet the original use test unless the IRS provides an exception or special rule.[121] The Treasury and the IRS are aware of the need for additional guidance with respect to the land and also with respect to the definition of what constitutes "original use" and the application of the test to tangible property, underutilized property and abandoned property.[122] Further, they are seeking comments on "what metrics would be appropriate for determining whether tangible property has 'original use' in an opportunity zone" and whether a "period of abandonment or under-utilization of tangible property [should] erase the

111. *See* I.R.C. § 1400Z-2(e)(4)(B) (2017); Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54280.
112. I.R.C. § 1400Z-2(e)(4).
113. *Id.* § 1400Z-2(e)(4)(B).
114. *Id.*
115. *Id.* § 1400Z-2(f)(1).
116. *Id.* § 1400Z-2(a)(1)(A).
117. I.R.C. § 1031 (2017).
118. *Id.* § 1031(a).
119. I.R.C. § 1400Z-2(d)(2)(D)(i)(II).
120. Maule, *supra* note 4, at 12.
121. *Id.* at 19.
122. *Id.* at 20; Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54279-01, 54279–80 (Oct. 29, 2018).

property's history of prior use in the" QOZ.[123] The IRS will hopefully provide guidance on this issue in the next set of proposed regulations.[124] QOFs attempting to purchase property within a QOZ will be taking a risk that the land purchased will not meet the "original use" requirement.[125] If a QOF fails to meet this requirement, the purchased property will not be considered Qualified Opportunity Zone Property and a QOF may lose all or part of its tax benefit.[126]

D. "Substantially All" Requirement

The proposed regulations defined "substantially all" to be a 70% threshold in the context of § 1400Z-2(d)(3)(A)(i); "[h]owever, the regulations do not address any of the other uses of this phrase throughout § 1400Z-2."[127] In § 1400Z-2(d)(2)(D), "substantially all" is not defined in this context, leaving QOZBs uncertain of the standard to be met.[128] The IRS is aware of this uncertainty and stated specifically that "comments are requested on whether any additional rules regarding the 'substantial improvement' requirement for tangible property are warranted or would be useful."[129]

Further, in § 1400Z-2(d), the phrase "substantially all" is used multiple times in a row, "(that is, 'substantially all of . . . substantially all of . . . substantially all of')."[130] The IRS failed to provide an interpretation of this, other than to say that "[t]his compounded use of substantially all must be interpreted in a manner that does not result in a fraction that is too small to implement the intent of Congress."[131] The Treasury Department and IRS are working on additional published guidance, and the meaning of "substantially all" is expected to be addressed.[132]

VI. CONCLUSION

Prior to release of the proposed regulations and revenue ruling, potential investors were hesitant to invest, and the lack of guidance was slowing or stopping transactions from moving forward. The proposed regulations provided clarifications for essential issues such as the termination date, ability to re-invest gains, certain types of interests and entity types permitted, and which gains can be deferred. The proposed regulations and revenue ruling provided definitions of several terms including "substantially all," "substantially improved," "qualified opportunity zone business property," and "original use." Yet, this guidance failed to completely resolve these issues because some terms were only defined in one context within §

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123. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54279–80.
124. *Id.* at 54280.
125. *See* I.R.C. § 1400Z-2(d)(2)(D)(i)(II) (2017).
126. *Id.* § 1400Z-2(a)(1)(A).
127. Maule, *supra* note 4, at 22.
128. *See* I.R.C. § 1400Z-2(d)(2)(D).
129. Investing in Qualified Opportunity Funds, 83 Fed. Reg. at 54279–80.
130. *Id.* at 54285.
131. *Id.*
132. *Id.* at 54280 (stating specifically, "[t]he forthcoming proposed regulations are expected to address other issues under [§] 1400Z-2 that are not addressed in these proposed regulations. Issues expected to be addressed include: The meaning of 'substantially all' in each of the various places where it appears in section 1400Z-2.").

1400Z.[133] Other issues concern the reasonable cause exception and the "original use" requirement as it applies to certain types of property.[134]

Although not all issues are resolved, the proposed regulations and revenue ruling are extremely helpful; they provided critical information allowing investors to understand this tax benefit opportunity.[135] While additional guidance would provide greater clarity to the unresolved issues described above, the guidance already published by the IRS and Treasury Department is a significant step in the right direction, ensuring that investors know the ground rules and feel comfortable sitting down and putting their chips on the table.

133. Milder, Wilson & Graff, *supra* note 45.
134. Maule, *supra* note 4.
135. *Id.*