



MILKEN  
INSTITUTE

---

---

# Opportunity Zone Vignettes

Real Estate: Workforce Housing

Operating Company: Grocery Store

A collaboration between **Milken Institute**, **Kirkland & Ellis LLP**, and **Ernst & Young LLP**

March 2020 (Updated)

---

---



# Disclaimer

The views, opinions, statements, analysis and information contained in these materials are those of the individual authors and do not necessarily reflect the views of the Milken Institute, Kirkland & Ellis or Ernst & Young or any of their past, present and future clients. These materials (1) do not constitute legal advice; (2) do not form the basis for the creation of the attorney/client relationship; and (3) should not be relied upon without seeking specific legal advice with respect to the particular facts and current state of the law applicable to any situation requiring legal advice. These materials may only be reproduced with the prior written consent of the Milken Institute, Kirkland & Ellis and Ernst & Young. These materials are provided with the understanding that the individual authors and the Milken Institute, Kirkland & Ellis and Ernst & Young are not rendering legal, accounting, or other professional advice or opinions on specific factors or matters, and, accordingly, such entities assume no liability whatsoever in connection with their use. Pursuant to applicable rules of professional conduct, this material may constitute Attorney Advertising. Prior results do not guarantee a similar outcome.

This presentation is provided solely for the purposes of enhancing knowledge on tax matters; it does not take into account any specific taxpayer's facts and circumstances. It is not intended, and should not be relied upon, as tax, accounting, or legal advice. Milken Institute, Kirkland & Ellis and Ernst & Young LLP expressly disclaims any liability in connection with the use of this presentation or its contents by any third party.

Neither Milken Institute, Kirkland & Ellis, Ernst & Young nor any member firm thereof shall bear any responsibility whatsoever for the content, accuracy, or security of any third-party websites that are linked (by way of hyperlink or otherwise) in this presentation.

The views expressed by the presenters are not necessarily those of Milken Institute, Kirkland & Ellis and Ernst & Young or other associated company or organization.

---

---



# Our Motivation

More than 50 million Americans live in economically distressed communities, and between 2000 and 2015 more than half of these communities experienced a decline in both jobs and businesses. The Opportunity Zone initiative is designed to assist these areas in their quest for economic growth and improved access to essential services. By affording investors tax incentives, the Opportunity Zone initiative provides the impetus to fund projects that will create jobs, improve education, develop affordable and workforce housing, advance access to health care, expand nutritional options, and ultimately improve lives across more than 8,700 communities.

Since 1991, the Milken Institute has championed initiatives designed to connect people, businesses, and communities to the resources they need to build meaningful lives. Together with Kirkland & Ellis and EY, the Institute has constructed illustrative vignettes to assist the U.S. Department of Treasury during the formulation of proposed regulations for the Opportunity Zone initiative.

The information provided herein is for illustrative purposes only. The Vignettes explore how Opportunity Fund investments might address specific obstacles facing the Opportunity Zones, such as access to jobs, housing, healthcare, nutrition, or infrastructure. By helping regulators and investors better understand any implementation challenges Opportunity Funds might face, we hope to expedite the investments that can produce financial returns – and, most importantly, generate positive social impact.



# Contents

I.	Background.....	4
A.	About this Reference Tool.....	5
B.	Overview of Opportunity Zone Initiative.....	6
II.	Workforce Housing Vignette.....	7
A.	Narrative Overview.....	8
B.	Legend / Definitions.....	9
C.	Vignette Timeline.....	10
1.	Forming an Opportunity Fund and Opportunity Zone Business and Acquiring Opportunity Zone Property.....	11
2.	Syndication of Opportunity Fund Interests.....	23
3.	Interim Refinancing & Distribution.....	25
4.	Failure to Meet 90% Test .....	27
5.	Interim Sale and Reinvestment into Opportunity Zone .....	29
6.	10-year Exit.....	31



# Contents (Cont.)

III. Grocery Store Vignette.....	34
A. Narrative Overview.....	35
B. Legend / Definitions.....	36
C. Vignette Timeline.....	37
1. Forming a Qualified Opportunity Fund, Creating a New Grocery Store Business, Constructing and Acquiring New Tangible Property, and Operating the Business.....	38
1. An Existing Grocery Store Business.....	45
2. Existing Grocery Store Real Estate and Equipment.....	48
3. QOZB Adjusts Business Model.....	52
4. Sale of Fund Interests.....	55
Appendix I: Compiled List of Needed IRS Clarifications for Workforce Vignette .....	57
Appendix II: Compiled List of Needed IRS Clarifications for Grocery Store Vignette.....	65
Contributors.....	75



# Part I

## Background

---

---



# IA. About this Reference Tool

## **Purpose**

The purpose of this document is to explain the benefits offered by the 2017 Tax Reform and Jobs Act, Subchapter Z on Opportunity Zones. Through a series of illustrative “vignettes”, this reference tool demonstrates how the Opportunity Zone initiative could impact a potential real estate development project or investment in an operating company. The vignettes trace a transaction from initial capital formation of an Opportunity Fund through the point of exiting an investment in an Opportunity Fund.

The Internal Revenue Service (“IRS”) and Treasury have recently provided final regulations to help clarify implementation of the Opportunity Zone initiative. Throughout these vignettes, we highlight what further information is needed from the IRS before the impact of a particular issue can be fully assessed. In addition, each aspect of the vignettes contains references to other areas of law that are pertinent to the issue presented. The Opportunity Zone initiative does not override other areas of law, and readers should evaluate the mechanics of the legislation with that in mind, as well as consult legal and accounting experts.

## **Approach to Interpreting the Vignettes**

Before reviewing the vignettes, here are three overarching points that will help readers digest the information and the Opportunity Zone initiative at large:

- 1. Qualified Opportunity Fund (“Opportunity Fund”)** – in the financial markets, the word “fund” typically implies the creation of a vehicle that aggregates investor commitments that subsequently will be deployed to many projects by a fund manager. Although some participants have taken this approach, others have suggested reversing the conventional process: the Opportunity Fund manager finds an individual project first and then raises investment for it.
- 2. Tax Accounting Treatment** – to follow the vignettes, it is best to think in terms of tax accounting treatment. An investor can trigger their participation in the program by selecting an individual capital gain that has been accounted for, and then electing to defer that gain for use in a Opportunity Fund. The investor does not need, for example, to receive the cash from the realized gain or to trace cash from gains to investments in a Opportunity Fund. The taxpayer would simply defer the selected gain and elect to include it in a future tax year– upon the earlier of (1) when its investment in a Opportunity Fund is sold, (2) in 2026, or (3) a gain “inclusion event.”
- 3. Decision Points** – each situation is different, and beginning in Section 2 of each vignette we present some common decisions that investors may need to evaluate, such as selling interests in their fund at a later stage or using interests in the fund as collateral for loans. After Section 1 of the vignette, the Sections are not inter-dependent and can be reviewed individually based on the interest of the reader.

# IB. Overview of the Opportunity Zone Initiative

As part of the 2017 Tax Cuts and Jobs Act, Subchapter Z established Opportunity Zones to encourage investment in low- to moderate-income communities through qualified opportunity funds (“Opportunity Funds”) through significant tax incentives. Across the US, more than 50 million people live in economically distressed communities, and the intent of the initiative is to attract investment to these areas in order to improve livelihoods.

An Opportunity Zone is a census tract designated by each state or territory and certified by the U.S. Treasury as eligible to receive private investments via Opportunity Funds. More than 8,700 Opportunity Zones have been designated across all 50 states, the District of Columbia, and 5 U.S. Territories.

An Opportunity Fund is a partnership or corporation set up for investing, either directly or indirectly through subsidiaries, in eligible property located in Opportunity Zones (“Opportunity Zone Business Property”).

Opportunity Fund Summary Tax Benefits	Opportunity Fund Summary Requirements
<ul style="list-style-type: none"><li>▪ Temporary tax deferral for all capital gains reinvested in an Opportunity Fund, lasting until the investment is sold, December 31, 2026, or a gain “inclusion event,” whichever is soonest.</li><li>▪ A 10% reduction of the original capital gain if the Opportunity Fund investment is held for 5+ years before the end of deferral; plus an additional 5% reduction if the investment is held for 7+ years before then.</li><li>▪ If an investor holds the Opportunity Fund investment for 10+ years, the investor also will permanently avoid capital gains taxes on any proceeds from the sale of the Opportunity Fund investment itself.</li></ul>	<ul style="list-style-type: none"><li>▪ Capitalized by capital gains within 180 days of being realized.</li><li>▪ Deploys, directly or indirectly through subsidiaries, at least 90% of its capital into Opportunity Zone Business Property.</li><li>▪ Main requirement for Opportunity Zone Business Property is that it is either (a) substantially improved, defined as the Opportunity Fund (or its subsidiary) more than doubling its basis in the property over a 30-month period or (b) originally used in an Opportunity Zone by the Opportunity Fund (or its subsidiary).</li></ul>







# Part II

## Workforce Housing Vignette

---

---



## IIA. Narrative Overview

Three brothers—Tim, Cory, and Steve—who are experienced real estate developers, hear that a major employer is moving to their town, and decide to spearhead the development of a workforce housing option for employees. The brothers have been learning about the new Opportunity Zone initiative and discover the new employer is going to be located in an Opportunity Zone.

Through their real estate development firm called 3RE they already own assets that have appreciated significantly. 3RE decides to sell the building and use the gains to establish a fund (“Fund”), intending for it to qualify as an Opportunity Fund. Fund then establishes a business (“Business”), intending for it to qualify as a qualified opportunity zone business (“Opportunity Zone Business”) that will undertake the new workforce housing project in the Opportunity Zone. Before Business secures commitments or finds an Opportunity Zone Property, 3RE provides a loan to Business for finding the new property and conducting diligence.

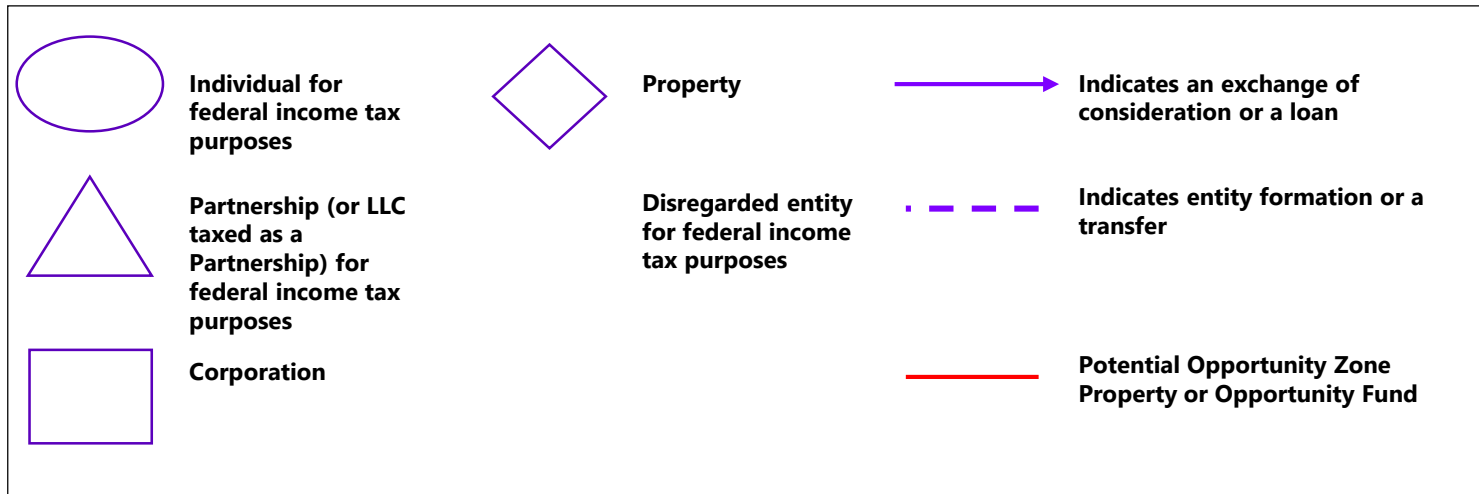
Fortunately, Business identifies a suitable project site consisting of land with some buildings, and 3RE commits equity to Fund to acquire the property. At the same time, the brothers’ friend Sara commits equity to Fund from gains that she realized on her stock portfolio. Business enters into a purchase and sale agreement to acquire the property, and draws on the 3RE loan to fund the pre-development work. At closing, the partners in Fund contribute their equity commitments (within 180 days of realizing gains), Fund contributes the cash to Business, and Business secures a community bank loan to refinance the 3RE loan and begin construction. The workforce housing project is constructed over the next two years, where Business draws the remaining loan proceeds to improve the property, and the partners evaluate whether to sell additional interests in Fund to further develop the project.

Over the course of its ownership in the workforce housing project, Business faces a number of decisions. Needing liquidity for another purpose, Business considers the impact of refinancing the housing project and distributing some of the proceeds to Fund and then to Fund’s partners. Similarly, it evaluates the impact of using interests in the Fund as collateral for a refinancing. In addition, other compelling investment opportunities arise. One of these potential investments is another Opportunity Zone Business Property, the sale of which would require Business to sell the existing housing project in order to participate. In addition, Business is interested in another investment opportunity that would not require it to sell the housing projects, but it is not in an Opportunity Zone and therefore could have consequences for the overall Opportunity Fund status.

At the end of 10 years, the Opportunity Fund has created thousands of workforce housing options for residents in their town. The Fund’s partners now wish to take advantage of the tax benefits and evaluate the optimal means to exit.

# IIB. Legend / Definitions

## Legend

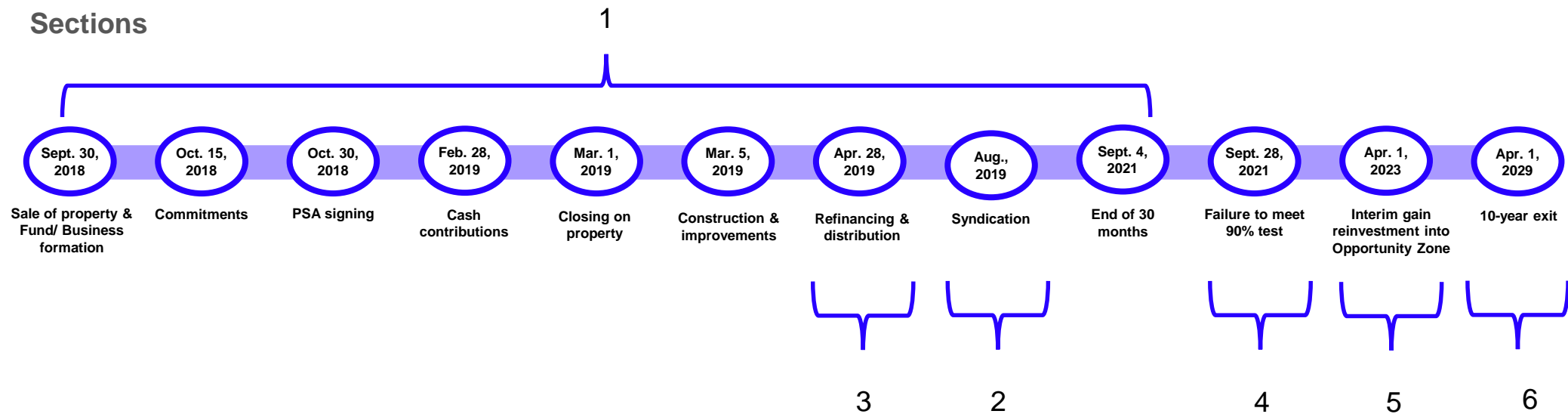


## Definitions

- "Opportunity Fund" – Qualified opportunity fund
- "Opportunity Zone" – Qualified opportunity zone
- "Opportunity Zone Business" – Qualified opportunity zone business
- "Opportunity Zone Business Property" – Qualified opportunity zone business property
- "Built-in-Gain Property" – An asset with fair market value in excess of tax basis
- "IRC" – The Internal Revenue Code of 1986, as amended

# IIC. Workforce Housing Vignette Timeline

The vignette will be presented in six sections that are typical of a standard real estate development project. Because Opportunity Zone benefits are linked to specific periods of time, it is critical to understand how its timeframes interact with these standard project processes. The vignette timeline is below and individual processes will be highlighted in the header of each section, allowing the reader to place each step in a broader context.

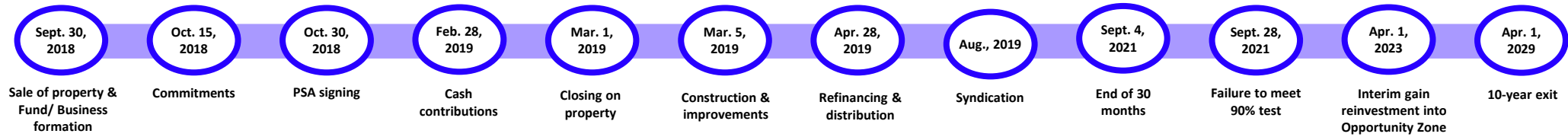




# IIC. Section 1:

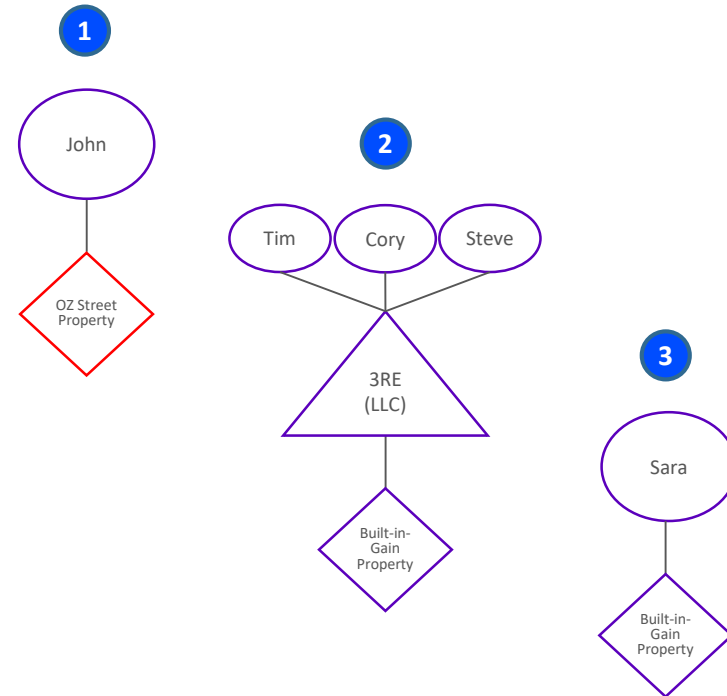
Forming an Opportunity Fund, Opportunity Fund,  
Opportunity Zone Business & Acquiring Opportunity Zone  
Business Property

## Section 1

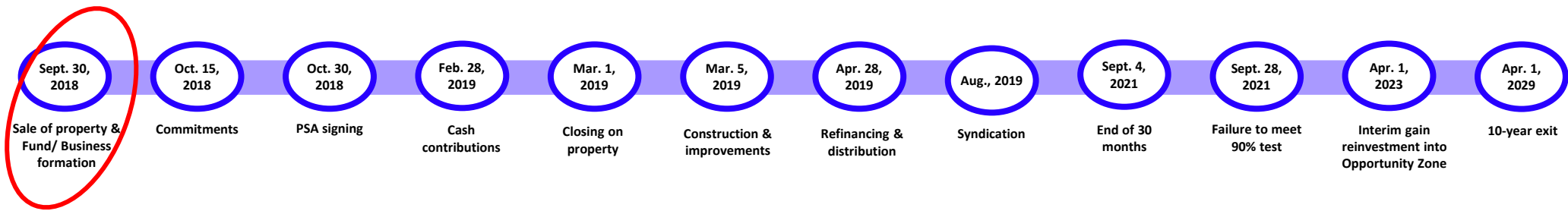


### Pre-Transaction Background Information

- 1 John holds a fee interest in real estate located in an Opportunity Zone (the "OZ Street Property"). The OZ Street Property consists solely of land and a few buildings.
- 2 3RE, LLC ("3RE") has 3 partners: Tim, Cory and Steve. 3RE holds assets with a fair market value of \$300 and a tax basis of \$220 (i.e., \$80 of built-in gain). Either 3RE or its partners will choose to reinvest their gains into an Opportunity Fund.
- 3 Sara holds assets with a fair market value of \$200 and a tax basis of \$80 (i.e., \$120 of built-in gain).



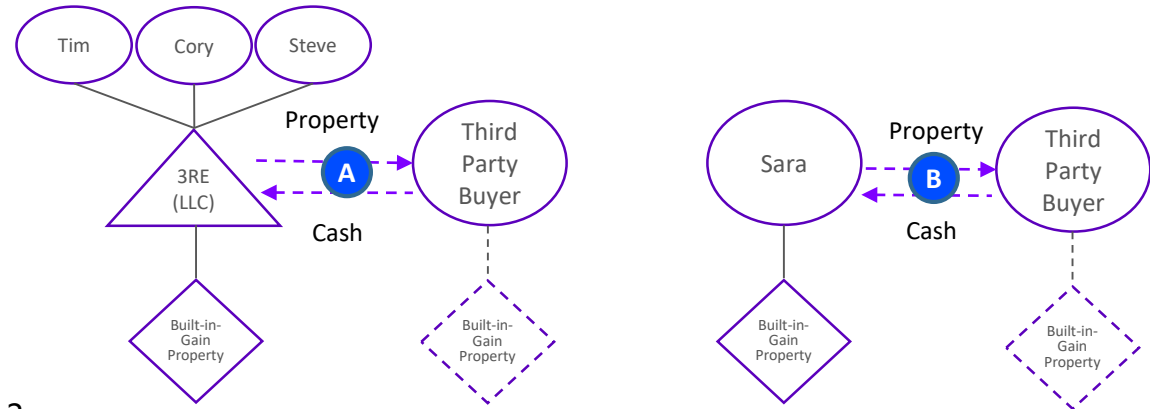
## Section 1



### Part 1: Sale of Built-in-Gain Property

**Step 1 A** On September 30, 2018, 3RE sells its Built-in-Gain Property for \$300 and realizes a gain of \$80.

**Step 1 B** Concurrently with Step 1A, Sara sells her Built-in-Gain Property for fair market value and realizes a gain of \$120.



### IRS Clarifications Needed

**Issue 1:** What types of gains may be invested in Opportunity Funds?

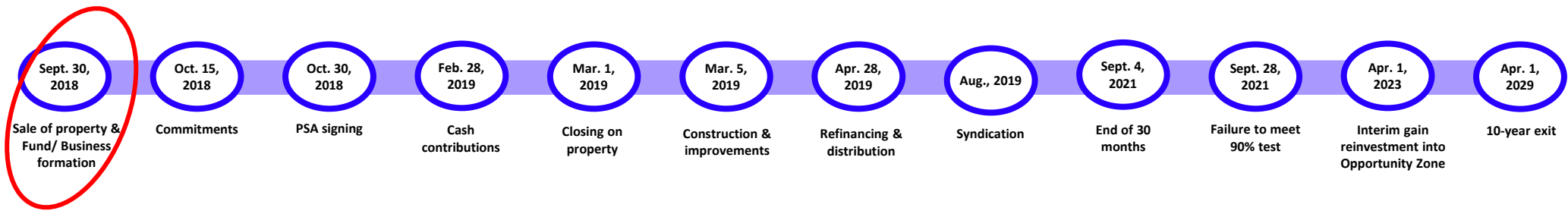
**Issue 2:** Will deferred gains recognized in 2026 have the same character and be subject to the same rate as when the deferral period began?

### Existing Clarifications

**Clarification 1:** Gains eligible for deferral must : (i) be "treated as a capital gain for Federal income tax purposes or is a qualified 1231 gain" (ii) otherwise be recognized before January 1, 2027 for Federal income tax purposes, and (iii) not arise from a sale or exchange with a person that is "related" to the taxpayer that recognizes or would recognize the gain within the meaning of IRC Section 1400Z-2(e)(2). Final Reg. 1.1400Z2(a)-1(b)(11)(i).

**Clarification 2:** If a taxpayer is required to include in income previously deferred gain, the gain so included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred. These attributes include those taken into account by sections 1(h), 1222, 1256, and any other applicable provisions of the IRC. The gain so included is subject to the Federal income tax provisions and rates that apply to other gains realized and recognized in the inclusion year. Final. Reg. 1.1400Z2(a)-1(c)(1).

## Section 1

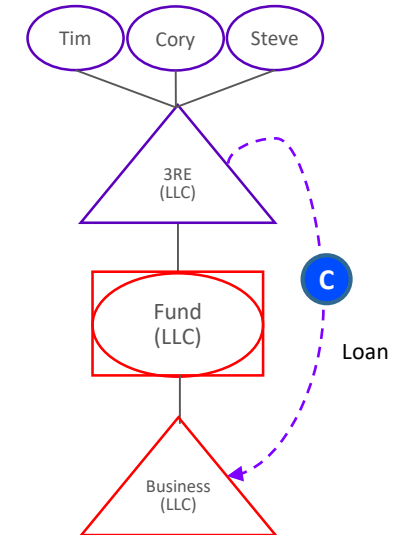
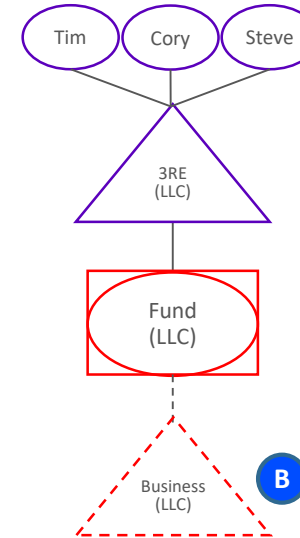
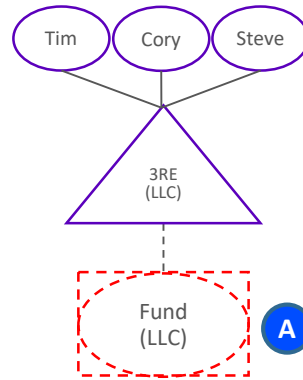


## Part 2: Formation of Fund

**Step 2 A** Immediately after Step 1A, 3RE forms Fund as an LLC. Fund is “organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund)” within the meaning of IRC Section 1400Z-2(d)(1).

**Step 2 B** Immediately after Step 2A, Fund forms Business as an LLC. Steve takes a de minimis interest in Business (not depicted) so Business is a partnership for tax purposes.

**Step 2 C** Immediately after Step 2B, 3RE lends \$60 to Business for pre-development costs.



## IRS Clarifications Needed

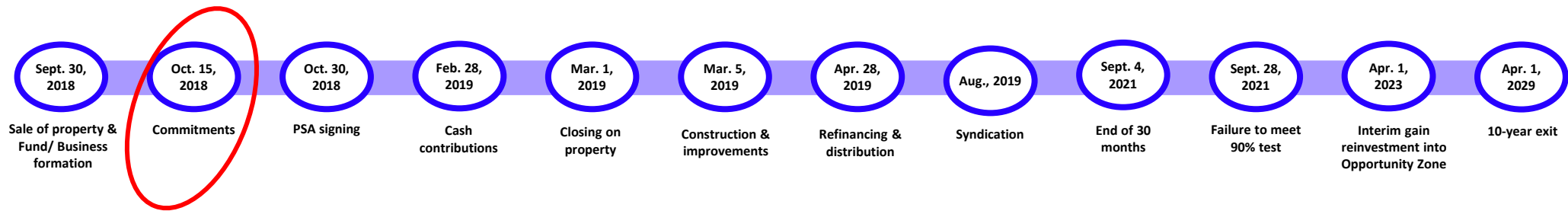
**Issue 3:** How does an entity become an Opportunity Fund?

## Existing Clarifications

**Clarification 3:** An entity classified as a corporation or partnership for Federal tax purposes that is eligible to be an Opportunity Fund self-certifies as an Opportunity Fund. Final Reg. 1.1400Z2(d)-1(a)(1)(i). The IRS has released Form 8996 for entities to self-certify. This form requires the entity to verify, among other things, that it is (i) either a corporation or partnership, (ii) “organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund),” and (iii) the entity’s organizing documents will include the statement of purpose in (ii) and describe the entity’s qualified opportunity zone business by the end of the entity’s “first qualified opportunity fund year.” The form is also used to verify annually that the entity meets the 90% Test or figure the penalty if the entity fails to meet the 90% Test. See IRS Form 8996 & instructions. In October 2019 the IRS released a new draft Form 8996 for the 2019 taxable year, which would also require reporting on the QOF’s holdings of Qualified Opportunity Zone Business Property and Qualified Opportunity Zone Business stock or partnership interests.



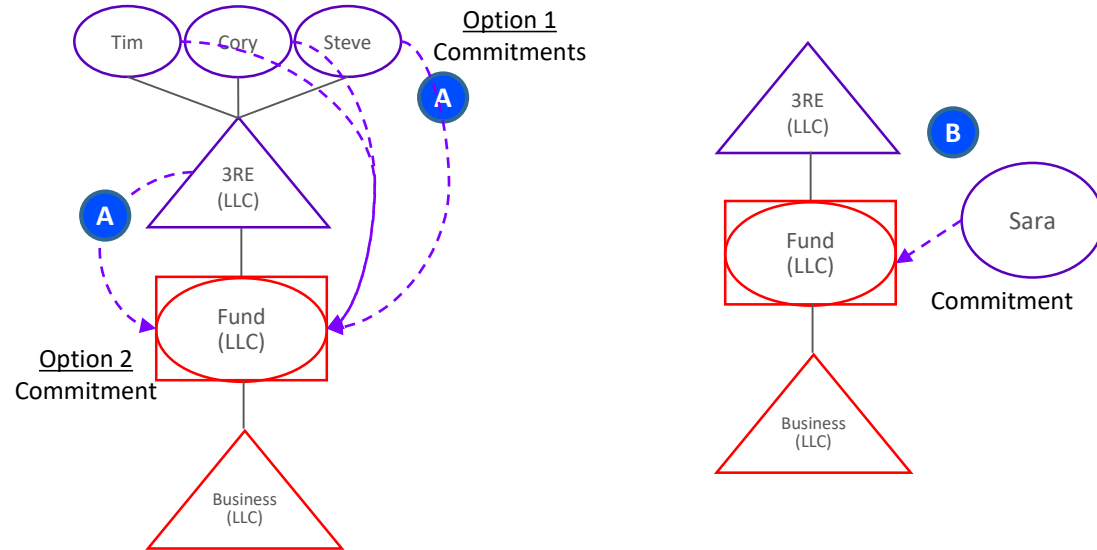
## Section 1



### Part 3: 3RE or partners commit to Fund

**Step 3 A** In October 15, 2018, either (1) 3RE, or (2) its partners, Tim, Cory, and Steve, sign a subscription agreement committing them to contribute \$80 of equity in the aggregate to Fund (the remainder of this vignette assumes that 3RE makes the investment).

**Step 3 B** Concurrently with Step 3A, Sara signs a subscription agreement, committing to contribute \$120 of equity to Fund.



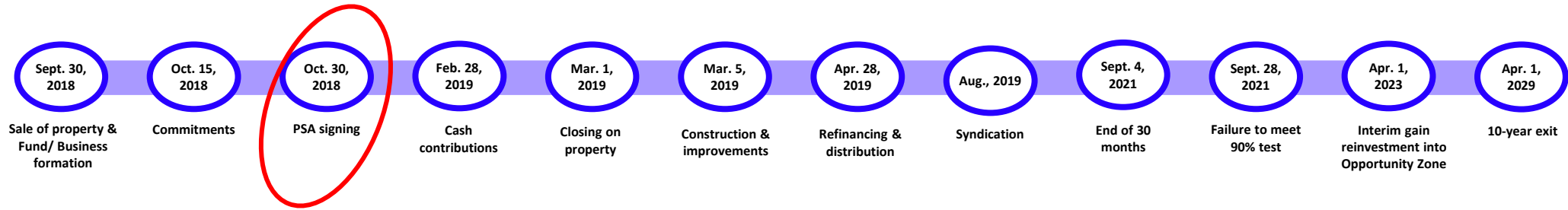
### IRS Clarifications Needed

**Issue 4:** Can either 3RE (Option 3A-1) or each 3RE partner (Option 3A-2) be the “taxpayer” that makes the investment into an Opportunity Fund?

### Existing Clarifications

**Clarification 4:** A partnership may elect to defer recognition of its eligible gains. If it does not elect to defer its eligible gains, the gains are included in the partners’ distributive shares under IRC section 702. If a partner’s distributive share includes eligible gains, the partner may elect to defer those gains. The 180-day period with respect to the partner’s eligible gains in the partner’s distributive share generally begins on the last day of the partnership taxable year in which the partner’s allocable share is taken into account under IRC section 706(a). However, generally the partner may elect to treat its own 180-day period as being the same as the partnership’s 180-day period or as beginning on the original due date for the partnership’s tax return for the taxable year in which the partnership realized the gain. Final Reg. 1.1400Z2(a)-1(c)(7)-(8).

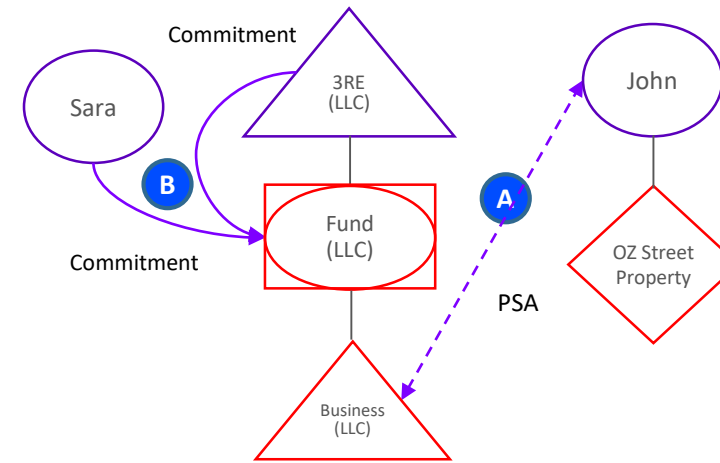
## Section 1



### Part 3: 3RE or partners commit to Fund

**Step 4 A** On October 30, 2018, Business enters into a purchase and sale agreement with John to purchase OZ Street Property for \$220 (the "PSA"). The PSA provides for the sale to occur on March 1, 2019.

**Step 4 B** After entering into the PSA and prior to Closing, Business uses the \$60 lent by the 3RE for due diligence, entitlement work, earnest money (cash deposits), and other pre-development costs.



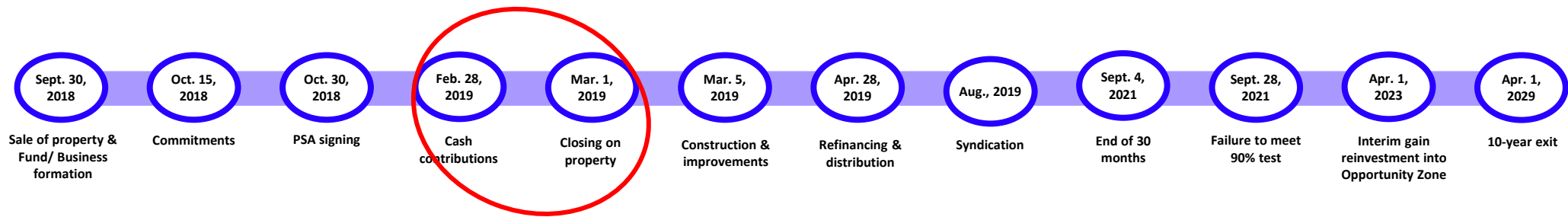
### IRS Clarifications Needed

**Issue 5:** How much cash is an Opportunity Zone Business (i.e., Business) permitted to have as "reasonable" working capital?

### Existing Clarifications

**Clarification 5:** Working capital is treated as reasonable in amount if: (i) the amounts are "designated in writing for the development of a trade or business in a qualified opportunity zone . . . , including when appropriate the acquisition, construction, and/or substantial improvement of tangible property" in an Opportunity Zone, (ii) "[t]here is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets," and working capital is spent within 31 months of receipt under the schedule, and (iii) "the working capital assets are actually used in a manner that is substantially consistent" with the plan and schedule. Final Reg. 1.1400Z2(d)-1(d)(3)(v).

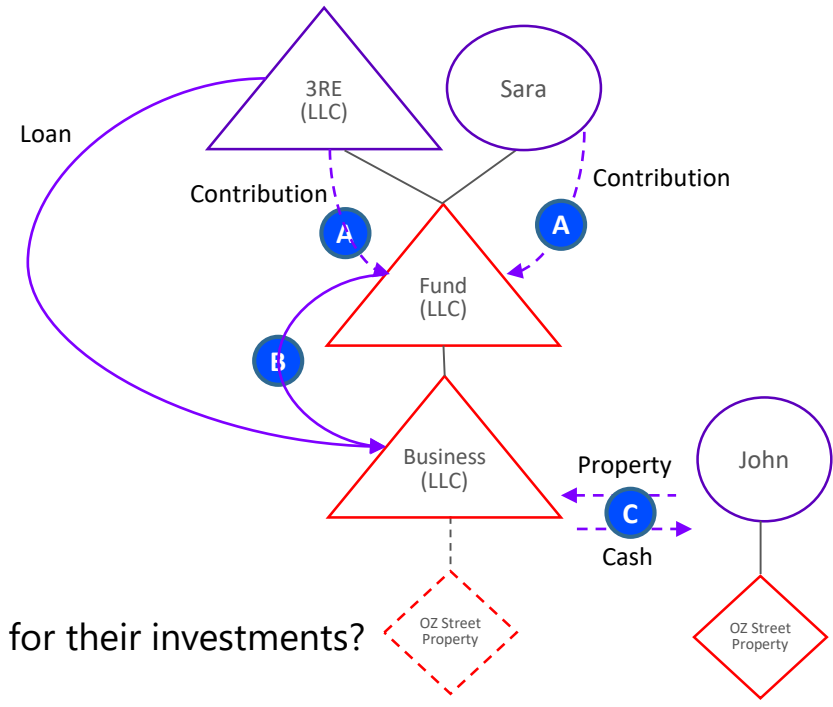
## Section 1



### Part 5: Closing on OZ Street Property

**Step 5 A** On February 28, 2019, 3RE contributes \$80 to Fund in exchange for an equity interest and profits interest in Fund, and Sara contributes \$120 to Fund in an exchange for an equity interest in Fund. 3RE and Sara agree to split all proceeds pro rata until each receives the amount of their initial contributions, and thereafter 50/50.

**Step 5 B** Immediately after Step 5A, Fund contributes the \$200 received to Business. Fund elects to be an Opportunity Fund on IRS Form 8996, designating February as its initial month.



### IRS Clarifications Needed

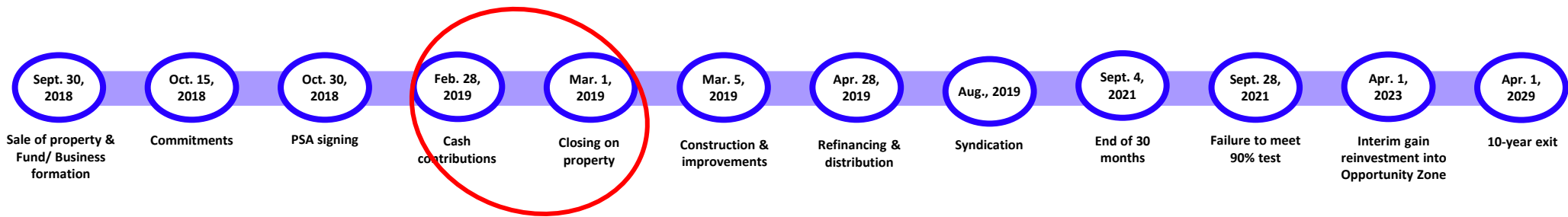
**Issue 6:** What kinds of interests may investors receive in Opportunity Funds for their investments?

### Existing Clarifications

**Clarification 6:** An "eligible interest" in an Opportunity Fund is an "equity interest" issued by the Opportunity Fund, "including preferred stock or a partnership interest with special allocations." Debt interests do not qualify. Final. Reg. 1.1400Z2(a)-1(b)(12). "A taxpayer makes an investment in a QOF by transferring cash or other property to a QOF." Services rendered to a QOF are not considered the making of a qualifying investment. Thus, "if a taxpayer receives an eligible interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is not a [qualifying investment]..." Final Reg. 1.1400Z2(a)-1(c)(5).

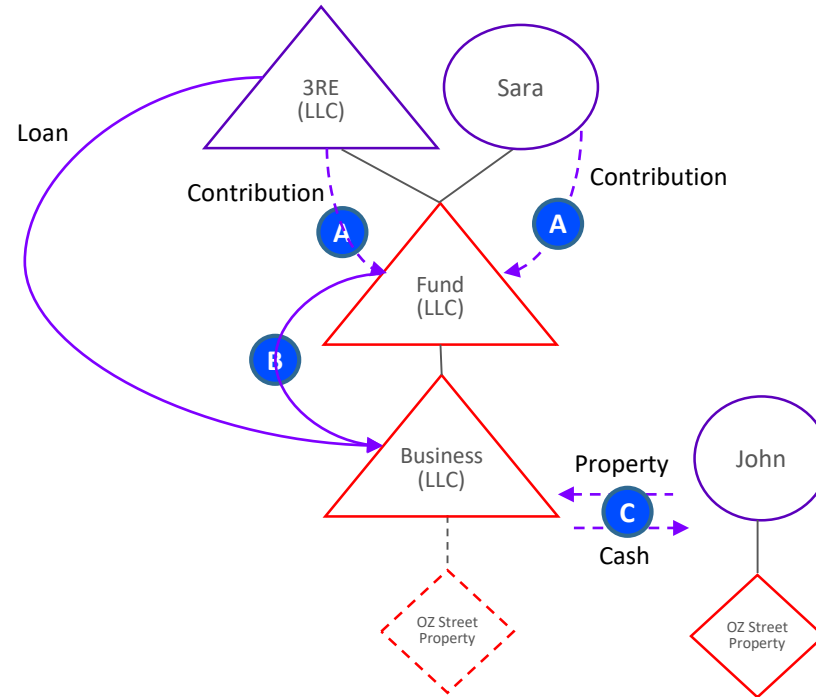


## Section 1



### Part 5: Closing on OZ Street Property

**Step 5 C** On March 1, 2019, Business uses \$220 (received in Steps 5B and 5D) to purchase the OZ Street Property pursuant to the PSA.



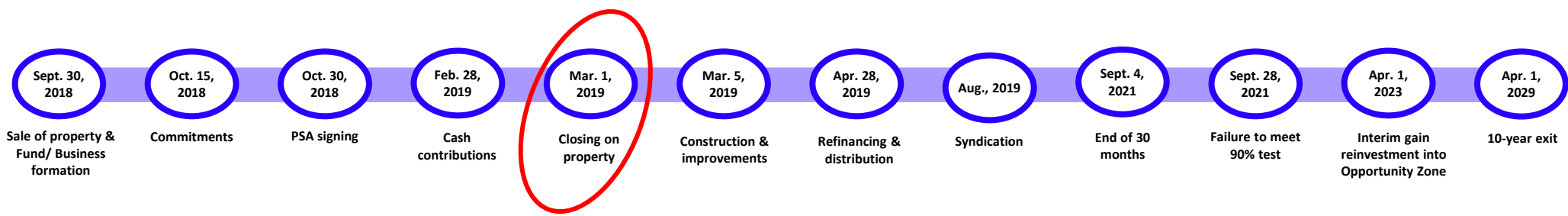
## IRS Clarifications Needed

**Issue 7:** When does Fund qualify as an Opportunity Fund? When must Fund satisfy the 90% Test?

### Existing Clarifications

**Clarification 7:** An entity must identify the first taxable year to be an Opportunity Fund on its self-certification. It may also identify the first month to be an Opportunity Fund. Opportunity Funds are subject to the requirement that they hold at least 90% of their assets in certain eligible property, measured on certain dates throughout the Opportunity Fund's taxable year (the "90% Test"). IRC section 1400Z-2(d)(1). The first testing date is the earlier of (i) the last day of the first 6 months each of which is in the taxable year and in each of which the entity is an Opportunity Fund and (ii) the last day of the taxable year. Final Reg. 1.1400Z2(d)-1(a)(2). On each testing date, the Opportunity Fund may choose to disregard property contributed to the QOF within the previous 6 months, so long as the property received by the QOF solely as a contribution or in exchange for stock and beginning on the fifth business day after the contribution or exchange the property is "held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less." Final Reg. 1.1400Z2(d)-1(b)(2)(B).

## Section 1



### Part 5: Closing on OZ Street Property

**Step 5 D** Concurrently with Step 5A, Business enters into a loan agreement and borrows \$20 from Community Bank. The loan agreement also provides that Business can borrow an additional \$260 to construct workforce housing on the OZ Street Property.

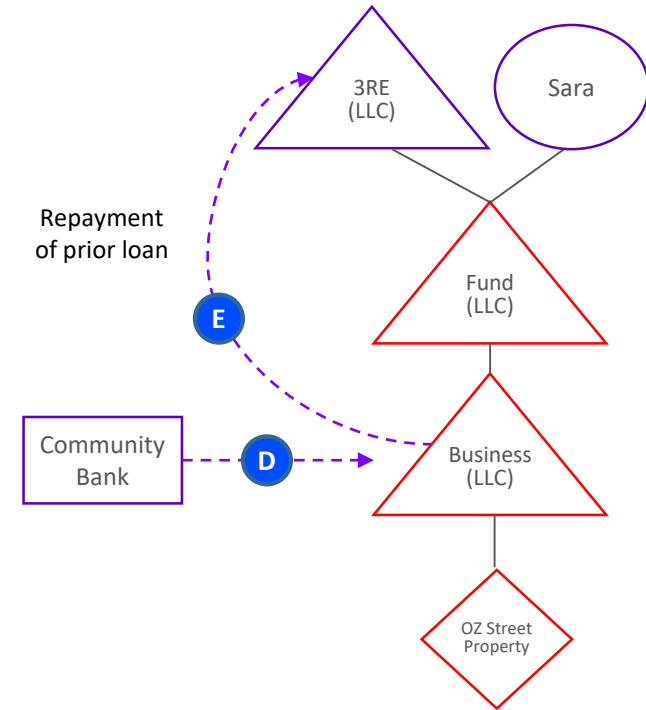
**Step 5 E** Immediately after Step 5D, Business uses \$60 to repay the loan from 3RE.

### IRS Clarifications Needed

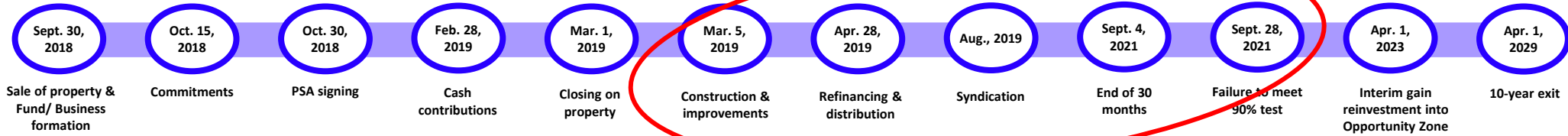
**Issue 8:** If Opportunity Funds (i.e., Fund) and Opportunity Zone Businesses (i.e., Business) borrow money, will debt allocated to the Opportunity Fund's partners cause all or a portion of their investments to be non-qualifying?

### Existing Clarifications

**Clarification 8:** The deemed contribution of money resulting from an increase in a partner's share of liabilities of a partnership under IRC section 752(a) does not create or increase an investment with mixed funds described in IRC Section 1400Z-2(e)(1). Final Reg. 1.1400Z2(a)-1(f)(2).



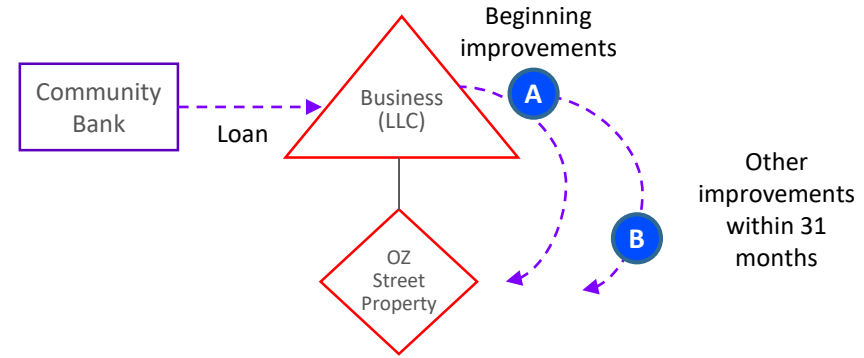
## Section 1



## Part 6: Improvement of OZ Street Property

**Step 6 A** On March 5, 2019, Business draws a portion of Community Bank’s loan and begins improvements and construction of workforce housing on the OZ Street Property.

**Step 6 B** By September 28, 2021 (31 months from receiving cash in Step 5A), Business draws the remainder of Community Bank’s loan and uses the proceeds to make improvements and construct the workforce housing project on the OZ Street Property.



## IRS Clarifications Needed

**Issue 9:** Is substantial improvement of the OZ Street Property measured with respect to the land (i.e., requiring improvements at least equal to the total acquisition cost allocated to land, or \$100) or the existing buildings (i.e., requiring improvement at least equal to the total acquisition cost allocated to the buildings, or \$180) or both (i.e., improvements at least equal to the total acquisition cost of \$280)?

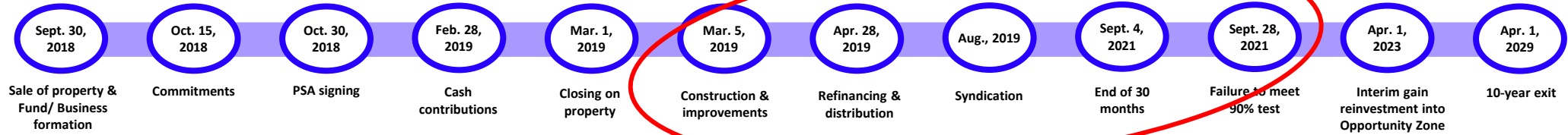
**Issue 10:** Will property be treated as substantially improved even if the improvements are not complete?

## Existing Clarifications

**Clarification 9:** If an Opportunity Fund purchases a building wholly within an Opportunity Zone, under IRC section 1400Z-2(d)(2)(D)(ii), a substantial improvement to the building is measured by the Opportunity Fund’s additions to the adjusted basis of the building. A substantial improvement to the building does not require the Opportunity Fund to separately substantially improve the land on which the building is located. Rev. Rul. 2018-29 and Final Reg. 1400Z2(d)-2(b)(4)(iv).

**Clarification 10:** If working capital is reasonable because of compliance with the safe harbor (see Clarification 5), and if the tangible property is expected to become substantially improved as a result of spending the working capital, then that property is treated as Opportunity Zone Business Property during the working capital periods. Final Reg. Sec. 1.1400Z2(d)-1(d)(3)(viii). Additionally, tangible property may benefit from multiple applications of the safe harbor for a total of 62-months. Final Reg. 1.1400Z2(d)-1(d)(3)(v)(F).

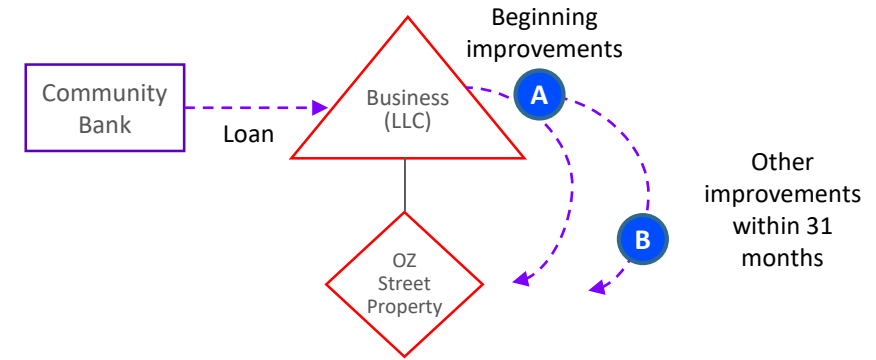
## Section 1



### Part 6: Improvement of OZ Street Property

**Step 6 A** On March 5, 2019, Business draws a portion of Community Bank’s loan and begins improvements and construction of workforce housing on the OZ Street Property.

**Step 6 B** By September 28, 2021 (31 months from receiving cash in Step 5A), Business draws the remainder of Community Bank’s loan and uses the proceeds to make improvements and construct the workforce housing project on the OZ Street Property.



### IRS Clarifications Needed

**Issue 11:** What percentage of Business’ property needs to be Opportunity Zone Business Property? How is this percentage calculated?

**Issue 12:** Will the lapse of Opportunity Zone status in 2028 prevent 3RE and Sara from receiving the benefits of holding Fund interests for 10 years?

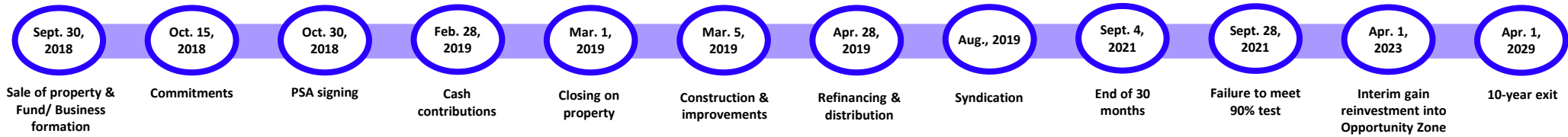
### Existing Clarifications

**Clarification 11:** Substantially all of the tangible property owned or leased by an Opportunity Zone Business must be Opportunity Zone Business Property. A trade or business of an entity is treated as satisfying the substantially all requirement if at least 70 percent of the tangible property owned or leased by the trade or business is “qualified opportunity zone business property.” If the entity has an “applicable financial statement” within the meaning of IRC section 1.475(a)-4(h), then Business may calculate compliance with the 70 percent requirement by using the value of each asset of the entity as reported on the financial statement for the relevant reporting period. Alternatively, the “value of tangible property owned . . . is the unadjusted cost basis of the property under section 1012” and the “value of tangible property that is leased . . . is equal to the present value of the leased tangible property.” Final Reg. 1.1400Z2(d)- 1(b)(2)(ii)(A) and 1.1400Z2(d)-1(b)(4).

**Clarification 12:** “The ability to make an election . . . for investments held for at least 10 years is not impaired solely because, under 1400Z-1(f), the designation of one or more [Opportunity Zones] ceases to be in effect.” Final Reg. 1.1400Z2(c)-1(c).



## Section 1



## Section 1 Financial Summary

### Equity Investments in Fund/Business

Investor	Gain deferred	Investment in Fund
3RE	\$80	\$80
Sara	\$120	\$120
<b>Total</b>	<b>\$200</b>	<b>\$200</b>

### Business Sources of Capital

Type of investment	Amount
Equity contributed	\$200
Borrowings	\$280
<b>Total investment</b>	<b>\$480</b>

### Business Uses of Capital (Substantial Improvement)

Cost	Amount	Allocation
Property purchase price	\$220	
Pre-development costs*	\$60	
Total acquisition costs	\$280	
Allocation to land		\$100
Allocation to buildings		\$180
Development costs	\$200 (at least equal to building's allocation)	
<b>Total costs</b>	<b>\$480</b>	

\*Some costs may instead be related to the purchase price or improvement costs.





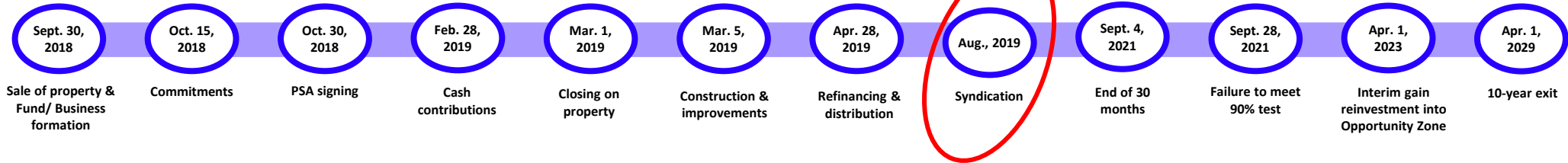
---

---

## IIC. Section 2:

Syndication of Opportunity Fund Interests

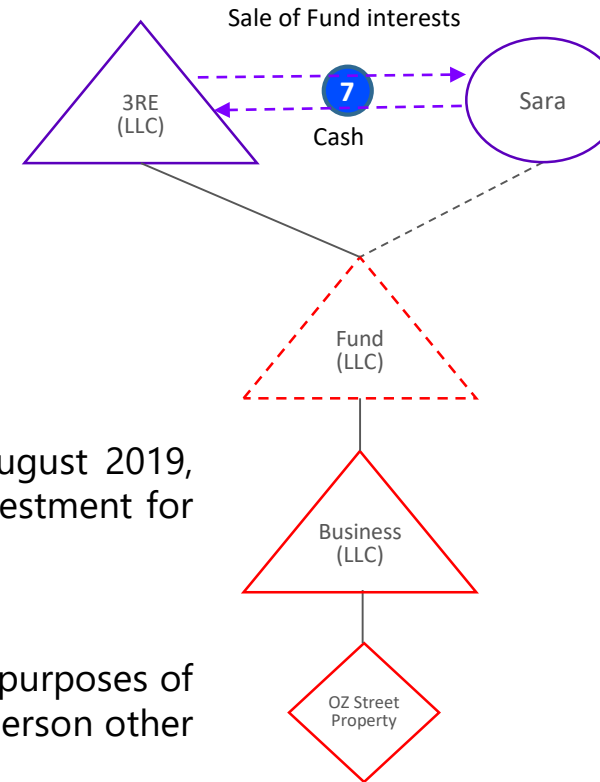
## Section 2



### (New) Part 7: Syndication of Opportunity Fund interests

Assume Steps 1-4 of Section 1 have occurred, 3RE contributes \$200 to Fund in Step 5, but Sara does not make a contribution.

**Step 7** In August 2019, 3RE sells a portion of its equity interests in Fund to Sara.



### IRS Clarifications Needed

Issue 13: Assuming Fund has already qualified as an Opportunity Fund by August 2019, does the purchase by Sara of the equity interests in the Fund qualify as an investment for purposes of the 180-day requirement?

### Existing Clarifications

Clarification 13: A taxpayer can make an investment in an Opportunity Fund for purposes of the 180-day requirement "by acquiring . . . an eligible interest in a QOF from a person other than the QOF." Final Reg. 1.1400Z2(a)-1(c)(6)(iv).



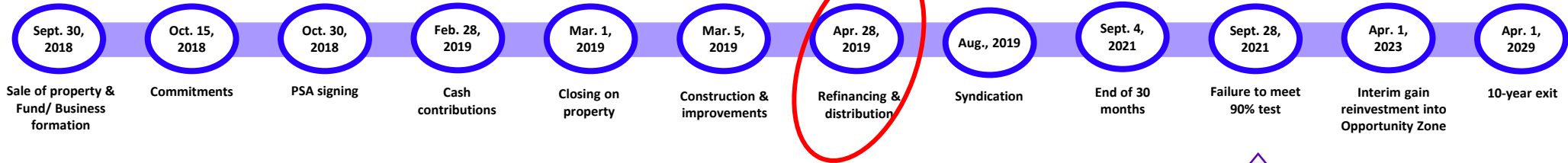
---

---

## IIC. Section 3:

### Interim Refinancing & Distribution

## Section 3



### **(New) Part 7: Interim refinancing & distribution**

The facts are the same in Section 1:

**Step 7 A** On April 28, 2019, Business enters into an additional loan agreement. Pursuant to the loan agreement, Business borrows \$80 from Community Bank 2 and pledges OZ Street Property as a security.

**Step 7 B** Immediately following Step 7A, Business distributes the \$80 received in Step 7A to Fund and Fund distributes the \$80 received to 3RE.

**Step 7 C** Immediately following Step 7B, Fund distributes the \$80 received to 3RE.

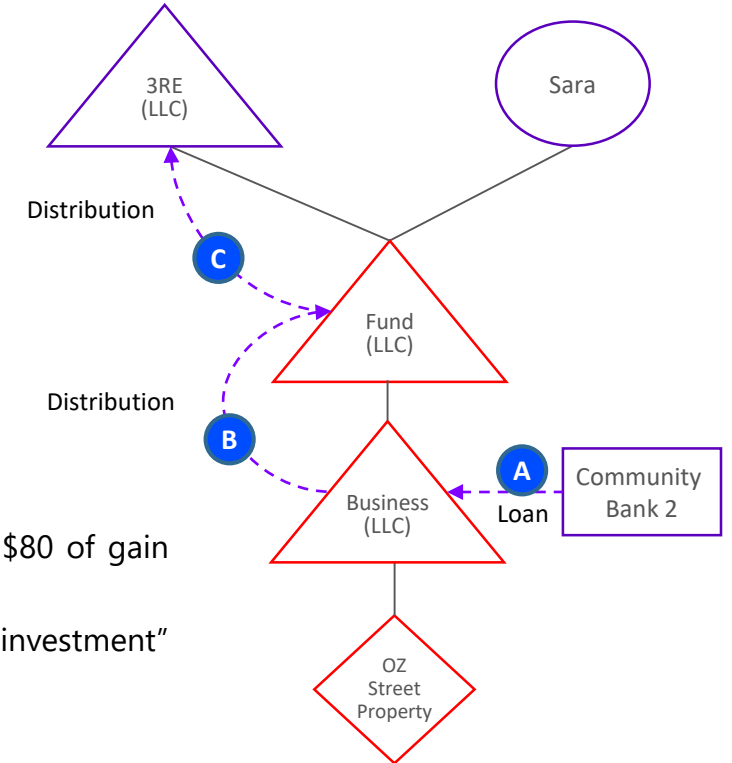
### **IRS Clarifications Needed**

**Issue 14A:** Is the distribution in Step 7C considered a sale or exchange such that 3RE is required to recognize the \$80 of gain reinvested in Step 5A?

**Issue 14B:** If the lender required personal guarantees from Sara and the partners of 3RE would that create a "mixed investment" under the IRC?

### **Existing Clarifications**

**Clarification 14A:** "An actual or deemed distribution of property, including cash, by a QOF partnership to a partner with response to its qualifying investment is an inclusion event," meaning gain equal to the distribution must be recognized, "only to the extent that the distributed property has a fair market value in excess of the partner's basis in the qualifying investment." Final Reg. 1.1400Z2(b)-1(c)(6)(iii). Under certain circumstances, the transfer to the partnership will not be treated as a qualifying investment to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution would be recharacterized as a disguised sale under IRC Section 707 if "(i) any cash contributed were non-cash property, and (ii) in the case of a distribution by the partnership to which §1.707-5(b) (relating to debt-financed distributions) applies, the partner's share of liabilities is zero." Final Reg. 1.1400Z2(a)-1(c)(6)(iii).





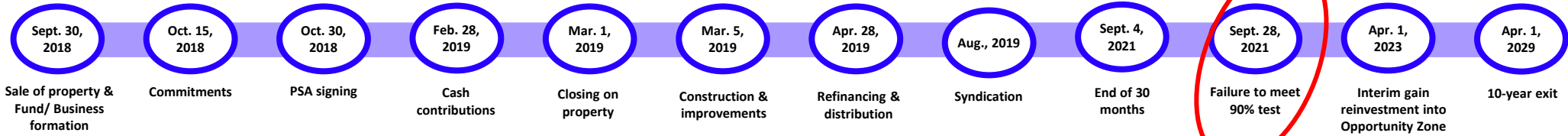
---

---

## IIC. Section 4:

Failure to Meet 90% Test

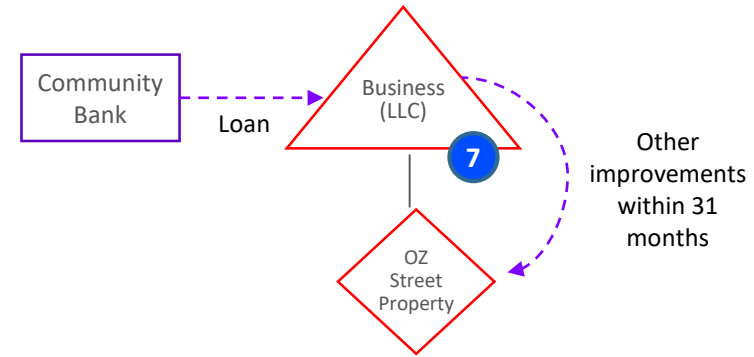
## Section 4



### **(New) Part 7: Failure to meet 90% Test**

Assume that Steps 1-6A of Section 1 have occurred.

**Step 7** By September 28, 2021, Business has borrowed and spent \$100 constructing workforce housing on the OZ Street Property and improving the existing buildings, but was unable to spend working capital “substantially consistent” within the meaning of Final Reg. 1.1400Z2(d)-1(d)(3)(v)(C) with its written plan and schedule within the 31 months after receipt.



### **IRS Clarifications Needed**

- Issue 15: Will Fund be treated as never having been an Opportunity Fund, cease to be an Opportunity Fund, or will it incur a penalty for each month it fails to qualify?
- Issue 16: If Fund incurs a penalty, how would the penalty be calculated? For how long may Fund fail to qualify before it loses Opportunity Fund status altogether, if ever?
- Issue 17: If Fund failed to qualify as an Opportunity Fund, would 3RE and Sara still be entitled to the deferral of their gains until the end of the 31-month period?

### **Existing Clarifications**

Clarification 15: To the extent that “consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete,” such delay would not be considered a failure to spend the working capital “substantially consistently” with its written plan and schedule within 31 months. Final Reg. 1.1400Z2(d)-1(d)(3)(v)(C). Additionally, if an Opportunity Zone Business is located in an Opportunity Zone “within a Federally declared disaster (as defined in section 165(i)(5)(A)),” then it “may receive up to an additional 24 months to consume its working capital assets.” Final Reg. 1.1400Z2(d)-1(d)(3)(v)(D). The Preamble to the Final Regulations notes that if an Opportunity Zone Business “fails to satisfy the conditions for applying a 31-month working capital safe harbor” and cannot satisfy the requirements to be an Opportunity Zone Business without the safe harbor then “such failure could cause a[n] [Opportunity Fund] to fail to satisfy the 90-percent investment standard, which would result in penalties.” TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(D)-1, O, 5.

Clarification 16: If a Fund “fails to satisfy the 90-percent asset investment standard . . . then the [fund] must pay the statutory penalty set forth in section 1400Z-2(f) for each month it fails to meet the 90-percent asset investment standard.” Final Reg. 1.1400Z2(f)-1(a). The Preamble to the Final Regulations provides that “the Treasury Department and the IRS continue to consider the circumstances under which involuntary decertification of a QOF would be warranted, and intend to propose guidance regarding those circumstances.” TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(d)-1, A, 3.



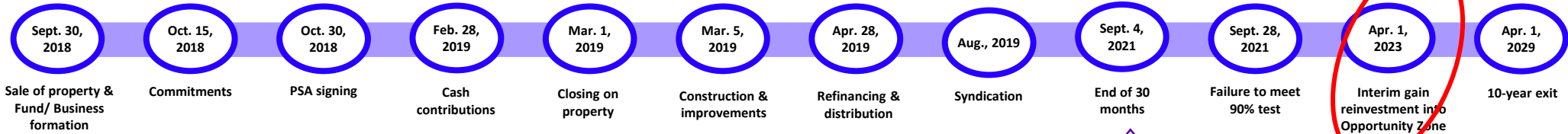
---

---

## IIC. Section 5:

Interim Sale & Reinvestment into Opportunity Zone  
Property

## Section 5

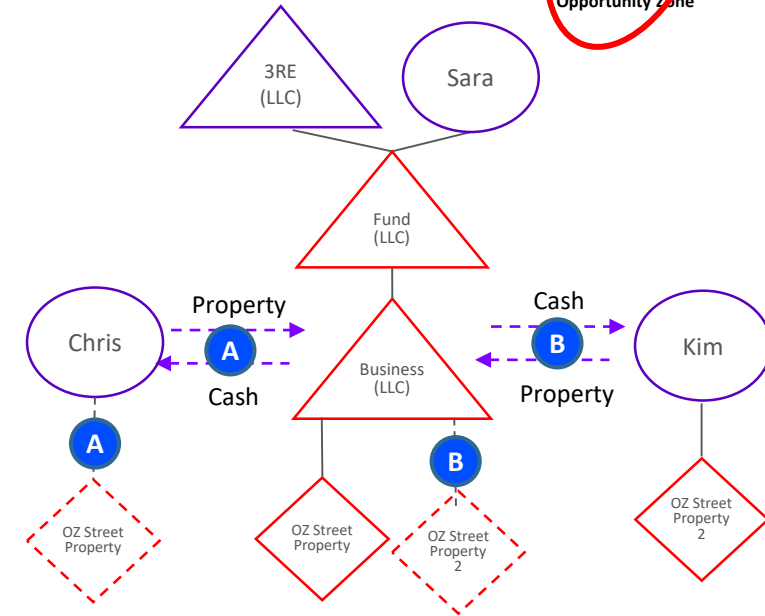


### **(New) Part 7: Interim sale & reinvestment into Opportunity Zone Property**

The facts are the same as in Section 1.

**Step 7 A** On April 1, 2023, Business sells the OZ Street Property (including the housing constructed thereon) to an unrelated buyer, Chris, for \$1,000, and realizes a gain of \$520.

**Step 7 B** 180 days after Step 7A, Business enters into a purchase and sale agreement to acquire OZ Street Property 2 from Kim, with the sale occurring upon signing.



### **IRS Clarifications Needed**

**Issue 18:** Will there be a grace period for Fund/Business to reinvest the proceeds from Step 7A into Opportunity Zone Business Property before needing to meeting the 90% Test?

**Issue 19:** Will 3RE and Sara be relieved from immediate taxation when Fund sells property and reinvests the proceeds into Opportunity Zone Business Property?

### **Existing Clarifications**

**Clarification 18:** The Fund has a “12-month period beginning on the date of the distribution, sale, or disposition” of Opportunity Zone Business Property to reinvest the proceeds into Opportunity Zone Business Property, so long as the proceeds “are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less.” If there is a delay in reinvestment due to “waiting for government action the application for which is complete, that delay does not cause a failure of the 12-month requirement.” If reinvestment by an Opportunity Fund “is delayed due to a Federally declared disaster,” then the Opportunity Fund “may receive up to an additional 12 months to reinvest such proceeds, provided that the [Opportunity Fund] invests such proceeds in the manner originally intended before the disaster.” Final Reg. 1.1400Z2(f)-1(b).

**Clarification 19:** There are currently no regulations permitting QOFs or their investors to avoid recognizing gain on the sale or disposition of assets before holding a QOF investment for at least 10 years.





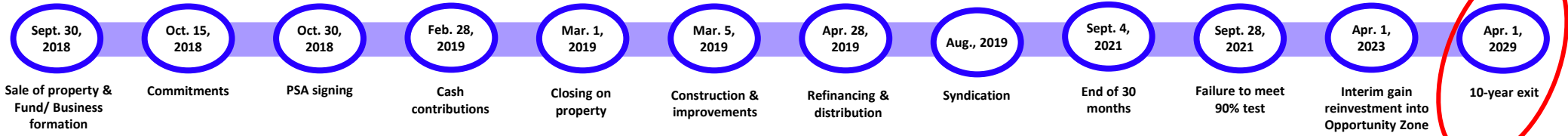
---

---

## IIC. Section 6:

10-year exit

## Section 6



### **(New) Part 7: Sale of Fund interests or OZ Street Property**

The facts from Section 1 are the same, and on April 1, 2029 either:

**Step 7 A** 3RE and Sara sell their interests in Fund, **OR B** Business sells the OZ Street Property. In each case the sale is to unrelated buyers for \$1,000, with gain of \$520 (\$100 of which is attributable to depreciation recapture). After repayment of the \$280 of debt, Business has \$720 to distribute to Fund and then to 3RE and Sara. 3RE and Sara are entitled to a return of their \$80 and \$120 initial investments. Of the remaining \$520, 3RE and Sara are each entitled to 50% (\$260).

### **IRS Clarifications Needed**

**Issue 20:** Do debt-financed gains realized by 3RE and Sara qualify for the benefits?

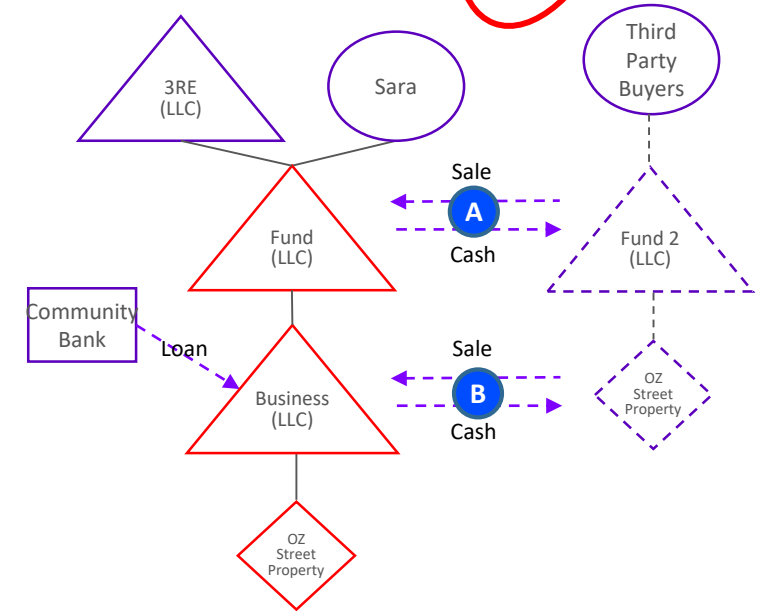
**Issue 21:** If Fund sells the OZ Street Property (i.e. Option B), does gain allocated to 3RE and Sara from that sale qualify for the benefits, or are the benefits only available in Option A?

**Issue 22:** Will the portion of 3RE and Sara's gain attributable to depreciation recapture qualify for the benefits? , whether or not an actual section 754 election is in place for any of the partnerships." Final Reg. 1.400Z2(c)-1(b)(2)(i).

### **Existing Clarifications**

**Clarification 21:** "If a taxpayer has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years . . . and the QOF partnership or QOF S corporation or any partnership that is owned, directly, or indirectly solely through one or more partnerships, by the QOF partnership or QOF S corporation disposes of the property, the taxpayer may make an election . . . to exclude from the taxpayer's income all gains and losses allocable to the qualifying investment that arise from all such sales or exchanges for the QOF partnership's or QOF S corporations taxable year." Final Reg. 1.400Z2(c)-1(b)(2)(ii)(A).

**Clarification 20, 22:** When a partner in a Fund makes an IRC 1400Z-2(c) election after ten years to adjust its basis to fair market value, "the basis of the QOF partnership interest is adjusted to an amount equal to the fair market value of the interest, plus the QOF partner's share of QOF partnership indebtedness under section 752 with respect to that interest, and immediately prior to the sale or exchange, the bases of the assets of the QOF partnership and of any partnership owned directly or indirectly by the QOF partnership solely through one or more partnerships are also adjusted with response to the disposed-of qualifying investment." These adjustments are calculated in a manner similar to the section 743(b) adjustments that would have been made if the transferor QOF partner purchased its interest in the QOF partnership for cash equal to the fair market value immediately prior to the sale or change, assuming that valid section 754 elections had been in place with respect to the QOF partnership and any partnerships directly or indirectly owned by the QOF partnership, whether or not an actual section 754 election is in place for any of the partnerships." Final Reg. 1.400Z2(c)-1(b)(2)(i).





---

---

# Part III

## Grocery Store Vignette

## IIIA. Narrative Overview

After closing on the OZ Street Property, the three brothers—Tim, Cory, and Steve— (“the brothers”) discover that their town does not have a grocery store with the capacity to provide the residents of their workforce housing development with access to fresh and healthy food. Currently, more than 54.4 million people, or 17.7% of the US population live in low-income tracts and are often more than 10 miles away from the nearest grocery store. Potential impacts of a local grocery store formation include declines in food insecurity, declines in prevalence of diabetes and fewer new diagnoses of high cholesterol and arthritis, increases in income of about \$1,500, and approximately 24 new jobs are created for every 10,000 square feet of retail grocery space. With this in mind, the brothers decide to invest in increasing access to fresh and healthy food in the QOZ for the benefit of the residents of their housing development, the entire QOZ, and the surrounding areas.

The brothers each have a stock portfolio that has appreciated significantly under their ownership. They decide to sell the portfolios and use the gains to establish a new QOF, contributing equity to the QOF within 180 days of when they realized gains from the stock portfolio sales. The QOF then uses its assets to invest in a subsidiary (a QOZB) that will either form a new grocery store business or acquire and expand an existing grocery store business.

Over the course of its ownership of a grocery store business, the QOF faces a number of decisions. The QOZB must construct new real estate, acquire existing real estate, or lease real estate in which it will operate a store. The QOF must decide what types of products the QOZB will sell and what it will do with the QOZB’s interim profits. The QOZB will also consider various changes to its business model, such as relocating, offering a delivery service for its customers, leasing its property to a third party, and franchising its business.

After ten years of operations the grocery store business has provided accessible healthy food options to local residents in the QOZ and created quality jobs. The brothers now wish to take advantage of the tax benefits and exit the QOF.

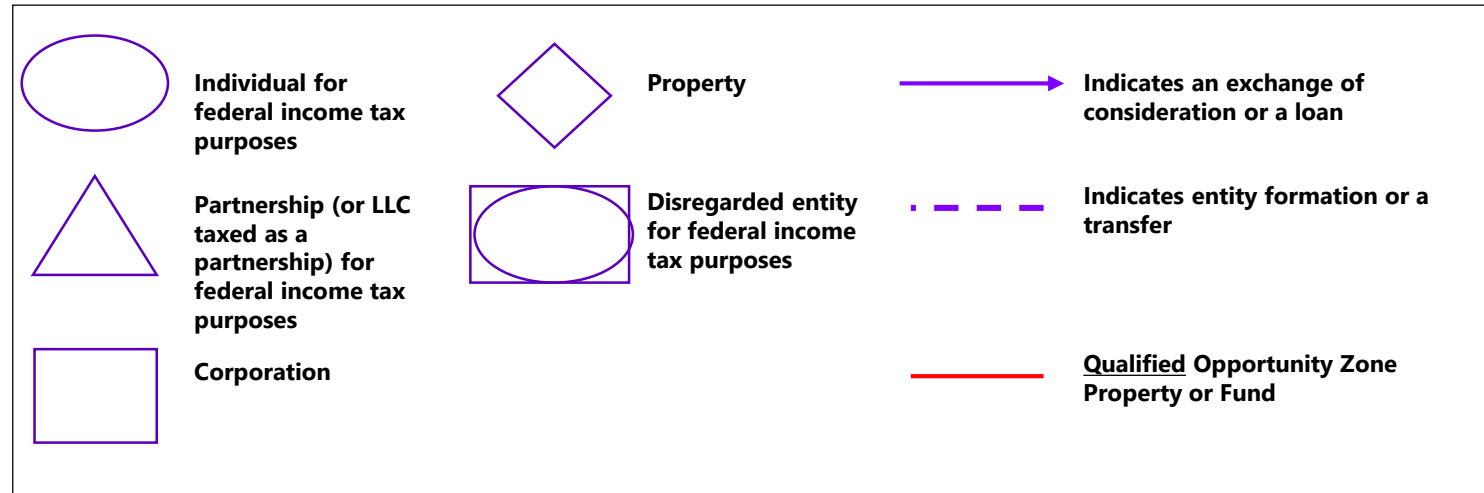
(1) United States Department of Agriculture

(2) RAND Corporation & CUNY Graduate School of Public Health and Health Policy

(3) The Food Trust

# IIB. Legend / Definitions

## Legend



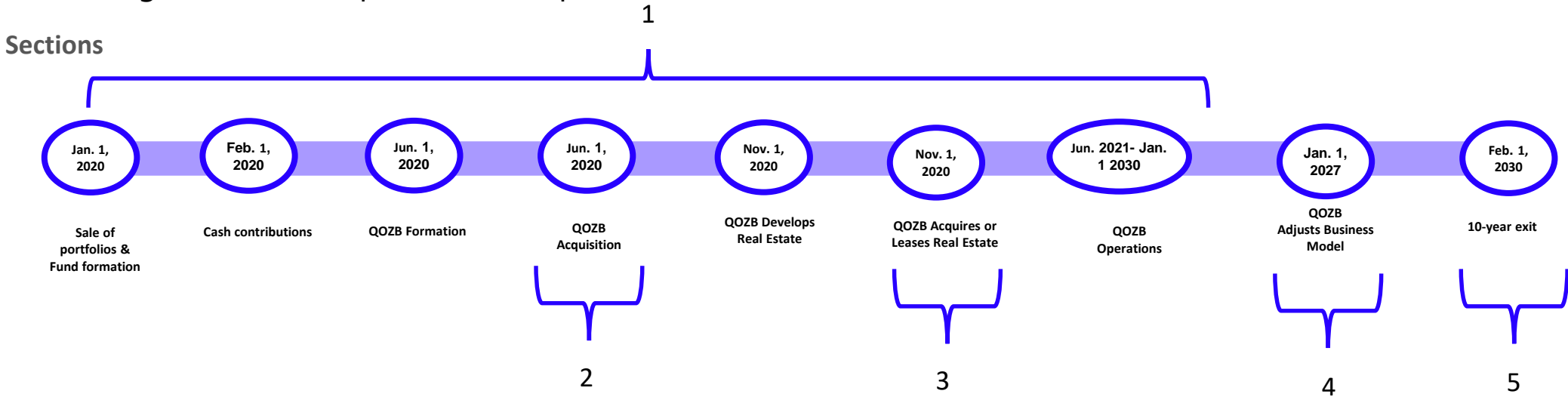
## Definitions

"QOF" – Qualified Opportunity Fund  
"QOZ" – Qualified Opportunity Zone  
"QOZP" – Qualified Opportunity Zone Property  
"QOZB" – Qualified Opportunity Zone Business  
"Built-in-Gain Property" – An asset with fair market value in excess of tax basis.  
"IRC" – The Internal Revenue Code of 1986, as amended.

# IIC. Grocery Store Vignette Timeline

The grocery store investment vignette is intended to focus on issues specific to the context of a QOF investing in a QOZB, with minimal discussion overlap with the issues related to QOZ investing that were already addressed in Part II. Accordingly, the vignette does not provide a comprehensive review of a QOZ investment. It instead presents the major milestones of a QOF investing in a QOZB with details added as relevant to discuss QOZB-specific issues. To the extent that issues pertaining to a QOF investing in a QOZB have been discussed in Part II, they are not repeated here in Part III. Please note that Part III is not meant to be reviewed in isolation, as it assumes knowledge of the issues discussed in Part II.

The grocery store investment vignette timeline is below and individual processes will be highlighted in the header of each section, allowing the reader to place each step in a broader context.





---

---

## IIC. Section 1:

Forming a Qualified Opportunity Fund, Creating a New Grocery Store Business, Constructing and Acquiring New Tangible Property, and Operating the Business

## Section 1

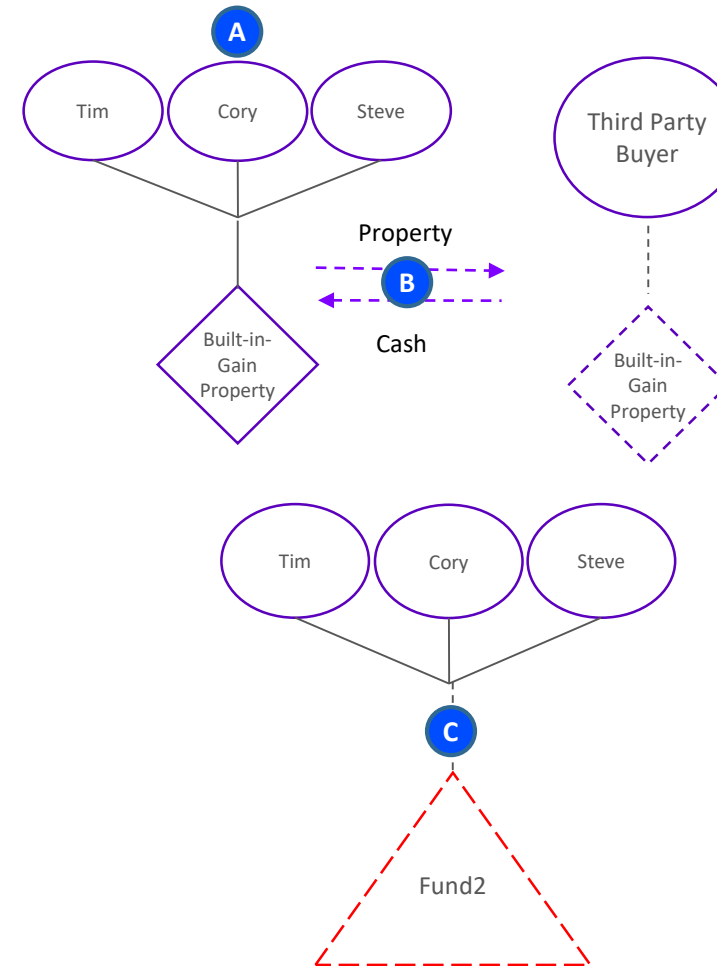


### Part 1: Sale of Built-in-Gain Property and Formation of Fund

**Step 1 A** The brothers, Tim, Cory and Steve, collectively have stock portfolios with a market value of \$110 and a tax basis of \$10 (i.e., \$100 of built-in gain).

**Step 1 B** The brothers sell their built-in-gain property to an unrelated party for \$110 and collectively realize a capital gain of \$100.

**Step 1 C** The brothers form Fund2 as a partnership. The brothers intend that Fund2 will satisfy all of the requirements to become a QOF and have a reasonable plan to do so. Fund2 self-certifies to be a QOF.



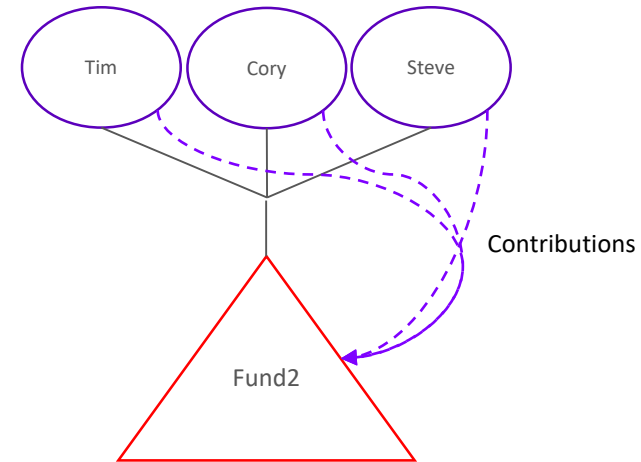


## Section 1

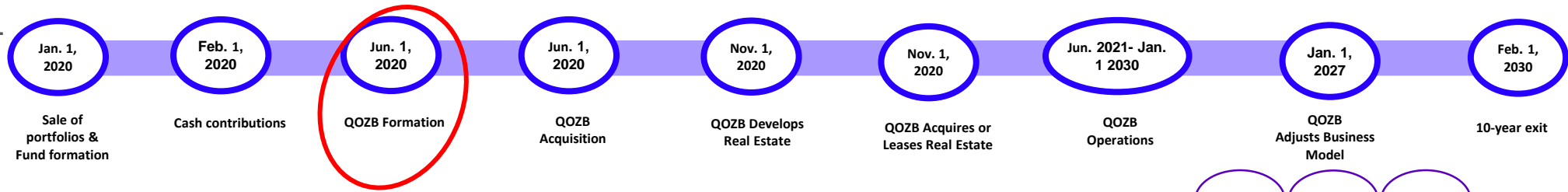


## Part 2: Cash Contributions

Step 2 The brothers collectively contribute \$100 to Fund2 in exchange for equal partnership interests. This cash contribution occurs within 180 days from when the brothers sold their stock portfolios. Tim, Cory, and Steve each have an equal ~33.33% partnership interest in Fund2.



## Section 1

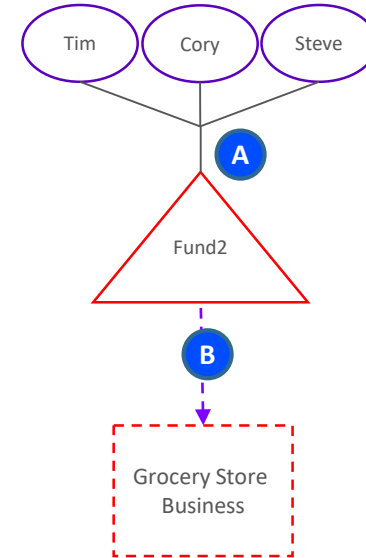


### Part 3: Business Formation

**Step 3 A** Fund2 organizes a new limited liability company, the “Grocery Store Business.” The company’s bylaws state that it has been organized for the purpose of being a QOZB and elects to be taxed as a corporation.

**Step 3 B** Fund2 contributes all of its assets (i.e., \$100) to the Grocery Store Business in direct exchange for 100% of the business’ membership units.

**Step 3 C** Having been capitalized by capital gains and using more than 90% of its assets to acquire units in a new business formed to be a QOZB, Fund2 becomes a QOF.



### IRS Clarifications Needed

**Issue 23:** Does it matter where a new business is organized for the purpose of being a QOZB (e.g., can a QOZB can be incorporated in Delaware or Puerto Rico)?

**Issue 24:** Can a QOZB be an LLC? Can a QOZB be a disregarded entity for tax purposes?

### Existing Clarifications

**Clarification 23:** An entity must be “organized under the law of the United States or one of the 50 states, a government of a Federally recognized tribe (Indian tribal government), the District of Columbia, or a U.S. territory” in order to qualify as a QOZB. “If an entity is organized in a U.S. territory but not in one of the 50 States or the District of Columbia,” the entity can only be a QOZB “if the entity conducts a qualified opportunity zone business in the U.S. territory in which the entity is organized.” Final Reg. 1.1400Z2(d)-1(a)(1)(ii).

**Clarification 24:** Interests in an entity can be qualified opportunity zone stock or qualified opportunity zone partnership interests if such entity is “classified as a corporation or partnership for Federal tax purposes.” Final Reg. 1.1400Z2(d)-1(a)(1)(i). The Preamble to the Final Regulations states that “transparent entities”, such as a qualified subchapter S subsidiary, a grantor trust, or an entity disregarded as separated from the QOF” will not be “treated as a qualified opportunity zone business in which the QOF has invested.” TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(d)-1, B, 1.

## Section 1

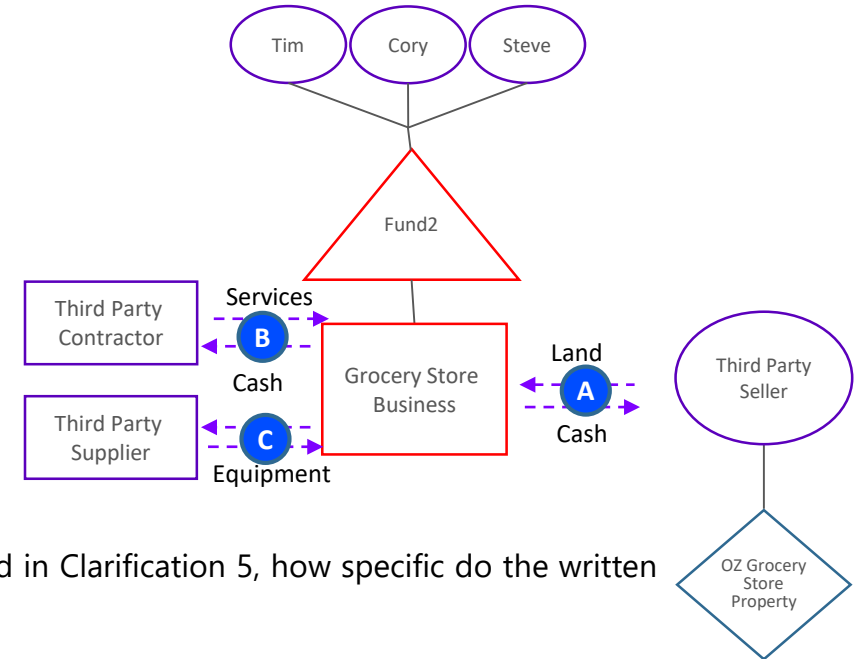


## Part 4: Business Develops Real Estate

**Step 4 A** The Grocery Store Business acquires a vacant plot of land located in a QOZ from an unrelated party for \$20.

**Step 4 B** The Grocery Store Business spends \$50 to construct a new building on the land to serve as a grocery store. Construction takes seven months.

**Step 4 C** The Grocery Store Business spends \$10 to acquire new equipment (e.g., refrigerators, cash registers, etc.) and installs the equipment in the store.



## IRS Clarifications Needed

**Issue 25:** In order to fall within the QOZB “safe harbor for reasonable amount of working capital” described in Clarification 5, how specific do the written plan and schedule need to be?

## Existing Clarifications

**Clarification 25:** The schedule must be “consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets.” Final Reg. 1.1400Z2(d)-1(c)(3)(v)(B). An example states that a QOZB with a plan and schedule specifying the following met the safe harbor: “[o]f the \$w million, \$x million was dedicated to the land purchase, \$y million to the construction of the building, and \$z million to ancillary but necessary expenditures for the project. The written plans provided for the purchase of the land within a month of receipt of the cash from QOF T and for the remaining \$y and \$z million to be spent within the next months on construction of the building and on the ancillary expenditures.” Final Reg. 1.1400Z2(d)-1(c)(v)(G)(3). There does not appear to be further guidance on the specificity required for the schedule and plan.

## Section 1



## Part 5: Operating the Grocery Store Business

**Step 5 A** In June 2021, the Grocery Store Business has completed its acquisition/development of real estate and equipment. The business hires and trains local residents to work in the store, opens its doors, and begins selling groceries.

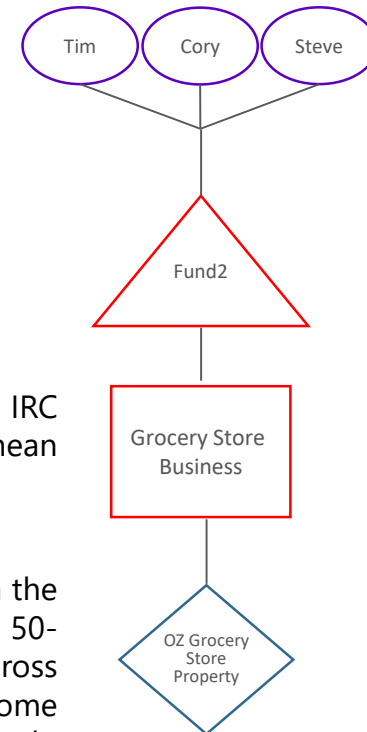
**Step 5 B** The Grocery Store Business does not become profitable until June 2022.

## IRS Clarifications Needed

**Issue 26:** During the period before the Grocery Store Business became profitable, was the business in compliance with the IRC Section 1397C(b)(2) requirement that a majority of its total gross income be derived from its active conduct? What does it mean to be a “trade or business” with “active conduct” in the QOZ context?

## Existing Clarifications

**Clarification 26:** If financial property is “treated as being a reasonable amount of working capital” because of compliance with the requirements for the “safe harbor for reasonable amount of working capital” then “[s]olely for purposes of applying the 50-percent test in section 1397C(b)(2) to the definition of a qualified opportunity zone business in section 1400Z-2(d)(3), if any gross income is derived from property” that the safe harbor “treats as a reasonable amount of working capital, then that gross income is counted toward satisfaction of the 50-percent test.” Final Reg. 1.1400Z2(d)-1(d)(3)(vi). Otherwise, the proposed regulations do not specify whether a business without income can satisfy the gross income requirement, but do provide safe harbors and a facts and circumstances test for determining whether a business’s income is sufficiently derived from its active conduct in a QOZ. See Clarification 37. The term “trade or business” is defined through reference to IRC Section 162, which delineates allowable deductions for trade or business expenses. Final Reg. 1.1400Z2(d)-1(d)(1).



## Section 1



## Part 5 (cont.): Operating the Grocery Store Business

**Step 5 C** The Grocery Store Business remains profitable and begins accumulating cash.

**Step 5 D** In 2024 the Grocery Store Business begins selling liquor and lottery tickets, in addition to groceries.

### IRS Clarifications Needed

**Issue 27:** Once the Grocery Store Business is profitable in June 2022, can it distribute those interim profits to Fund2 and out to the brothers? Is there a risk that such distributions would be considered a redemption instead of a return on investment? Does the amount of the distribution in "excess of basis" matter?

**Issue 28:** Can the QOZB accumulate cash instead of distributing or reinvesting? Would increasing cash reserves not earmarked for deployment run afoul of the IRC Section 1397C(b)(8) limit on nonqualified financial property and the carve-out for working capital? How is "working capital" defined in a QOZB context after a reserve is built?

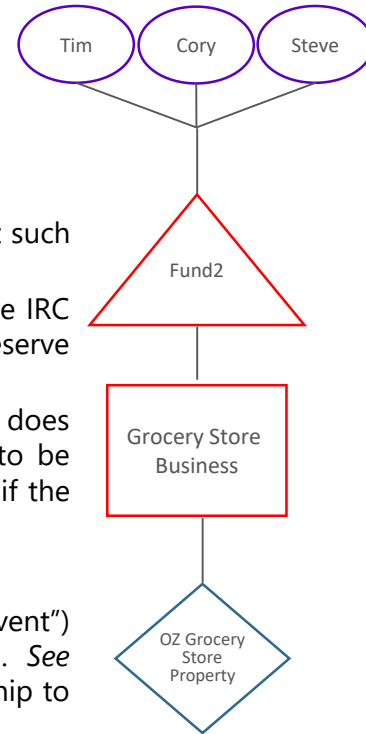
**Issue 29:** At what point is a store's sale of alcoholic beverages for consumption off premises considered to be the store's "principal business"? At what point does selling lottery tickets mean that a store is a "facility used for gambling"? What percentage of revenue must be attributable to an activity for the activity to be considered the "principal business" and over what time period is this percentage tested? Is the percentage tested at the store level or the business level (i.e., if the Grocery Store Business owns multiple grocery stores)?

### Existing Clarifications

**Clarification 27:** A QOF partnership's "actual or deemed distribution of property, including cash" will be considered a redemption (also known as an "inclusion event") "to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment." Final Reg. 1.1400Z2(b)-1(c)(6)(iii). See also Clarification 14A and Example 10 of Final Reg. 1.1400Z2(b)-1(f), where a partner was not required to recognize gain on a distribution from a QOF partnership to the extent of the partner's basis (including debt allocations under IRC 752) in the partnership.

**Clarification 28:** The safe harbor for working capital allows for working capital assets to be held not only for the acquisition and development of tangible property, but also more generally for business development. Final Reg. 1.1400Z2(d)-1(d)(3)(v)(A). The regulations do not provide specific guidance on working capital accumulated from revenue outside of the safe harbor period.

**Clarification 29:** "De minimis amounts of gross income attributable to a business described in section 144(c)(6)(B)," which are "sin businesses" such as liquor stores and gambling facilities, "will not cause a trade or business to fail to be a qualified opportunity zone business." "The term de minimis amount of gross income . . . means less than 5 percent of the gross income of the qualified opportunity zone business may be attributable to the type of business described in section 144(c)(6)(B)." Final Reg. 1.1400Z2(d)-1(d)(4)(ii)-(iii). In addition to the limitation on operating a "sin business," a QOZB also cannot lease "more than a de minimis amount of property" to a "sin business." Final Reg. 1.1400Z2(d)-1(d)(4)(i). In this context "de minimis" is defined as "less than 5 percent or the net rentable square feet for real property and less than 5 percent of the value of all other tangible property." Final Reg. 1.1400Z2(d)-1(d)(4)(iii).





---

---

## IIC. Section 2:

An Existing Grocery Store Business

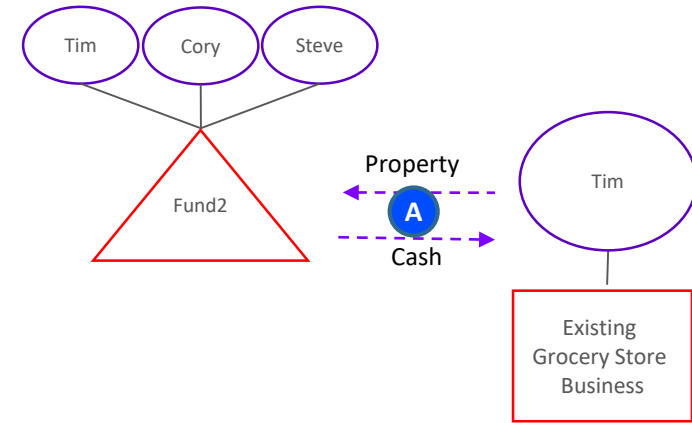
## Section 2



### **(New) Part 3: Business Acquisition**

Assume Steps 1-2 of Section 1 have occurred, the brothers sell their stock portfolios, form a QOF, and contribute equity. In Step 3, rather than having the QOF form a new business, assume that one of the brothers, Tim, already owns and operates a OZ Grocery Store Business. The brothers decide that the QOF will acquire Tim's business and invest in expansion.

Step 3: **A** Tim has a ~33.33% ownership interest in Fund2 and a 100% ownership interest in his existing Grocery Store Business. On June 1, 2020, Fund2 acquires Tim's existing OZ Grocery Store business, paying \$100 cash in direct exchange for 100% of its membership units.



### **IRS Clarifications Needed**

Issue 30: Can a pre-existing entity be a QOZB?

Issue 31: Can equity interests acquired by a QOF from a business' existing equity owners qualify as qualified opportunity zone stock or qualified opportunity zone partnership interests?

### **Existing Clarifications**

Clarification 30: "There is no legal barrier to a pre-existing eligible entity qualifying as a QOF or a qualified opportunity zone business, but the pre-existing eligible entity must satisfy all of the applicable requirements of section 1400Z-2" and the Final Regulations. Final Reg. 1400Z2(d)-1(a)(1)(iii).

Clarification 31: Qualified opportunity zone stock must be acquired by a QOF "at its original issue (directly or through an underwriter) from the corporation" and qualified opportunity zone partnership interests must be acquired "from the partnership." IRC 1400Z-2(d)(2)(B)-(C).

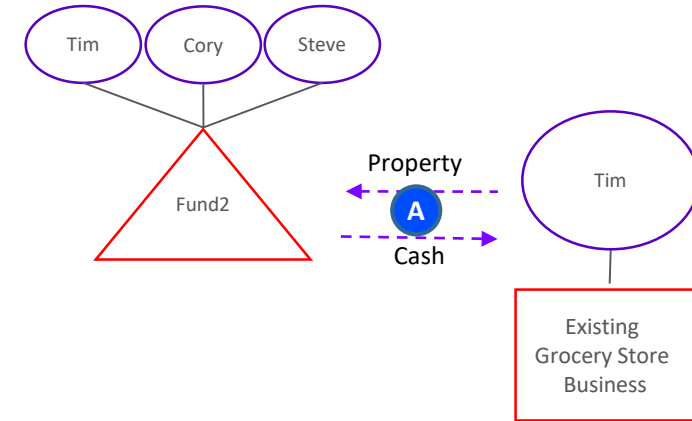
## Section 2



### **(New) Part 3: Business Acquisition (cont.)**

Assume Steps 1-2 of Section 1 have occurred, but the plan to acquire Tim's business falls through.

Step 3: **B** Fund2 begins a good faith effort to acquire a different existing grocery store business. It makes offers to acquire two other businesses, but neither offer is accepted. The brothers are not interested in starting a grocery store business from scratch. After two years of unsuccessfully attempting to acquire an existing grocery store business, the brothers pull their money out of Fund2.



### **IRS Clarifications Needed**

Issue 32: What are the consequences if the brothers are unable to execute on the business plan and pull their money out of Fund2 after two years? Do the brothers receive the benefit of a two year deferral because of their good faith effort to properly invest in a QOF and acquire QOZP? If so, what is required to show good faith? If the brothers should not have received the benefit of the two year deferral despite their good faith efforts, are they penalized for underpaying their taxes?

### **Existing Clarifications**

Clarification 32: The Final Regulations provide a 6-month cure period for qualified opportunity zone business, under which "the QOF may treat the stock or partnership interest in that business as qualified opportunity zone property for that semiannual testing date provided the business corrects the failure within 6 months of the date on which the stock or partnership interest lost its qualification." A QOF is only allowed to benefit from one six-month cure period. Final Reg. 1.1400Z2(d)-1(d)(6). Per the Preamble to the Final Regulations, "in addition to this six-month cure period, a QOF can assert a defense of reasonable cause under section 1400Z-2(f)(3)." TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(d)-1, G, 6. In terms of what constitutes "reasonable cause," the Treasury and IRS direct taxpayers to "the general standards set out in the 'Penalty Handbook,' which is included in Internal Revenue Manual (IRM) at section 20.1." TD 9889, Comments Not Specifically on Regulatory Text, F. The Preamble also provides that "the Treasury Department and the IRS continue to consider the circumstances under which involuntary decertification of a QOF would be warranted, and intend to propose guidance regarding those circumstances." TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(d)-1, A, 3.





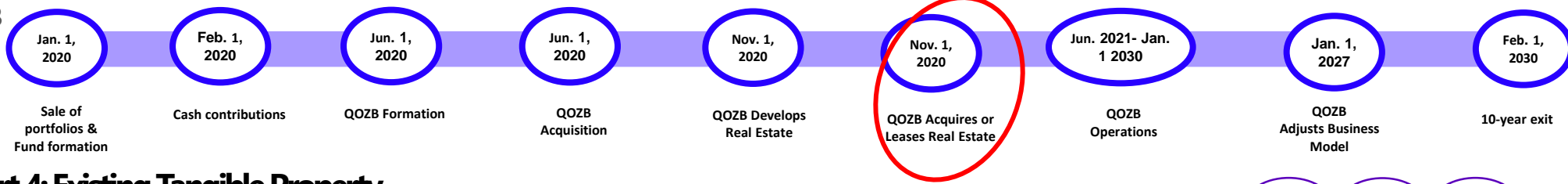
---

---

## IIC. Section 3:

Existing Grocery Store Real Estate and Equipment

### Section 3



### **(New) Part 4: Existing Tangible Property**

Assume Steps 1-3 of Section 1 have occurred, the brothers sell their stock portfolios, form a QOF, contribute equity, and the QOF creates a new business. In Step 4, rather than the QOZB constructing a store and buying new equipment, the QOZB acquires an existing building that was previously used as a grocery store and already has the necessary equipment.

**Step 4: A** The Grocery Store Business pays \$50 cash to acquire the building located in an QOZ, including the equipment.

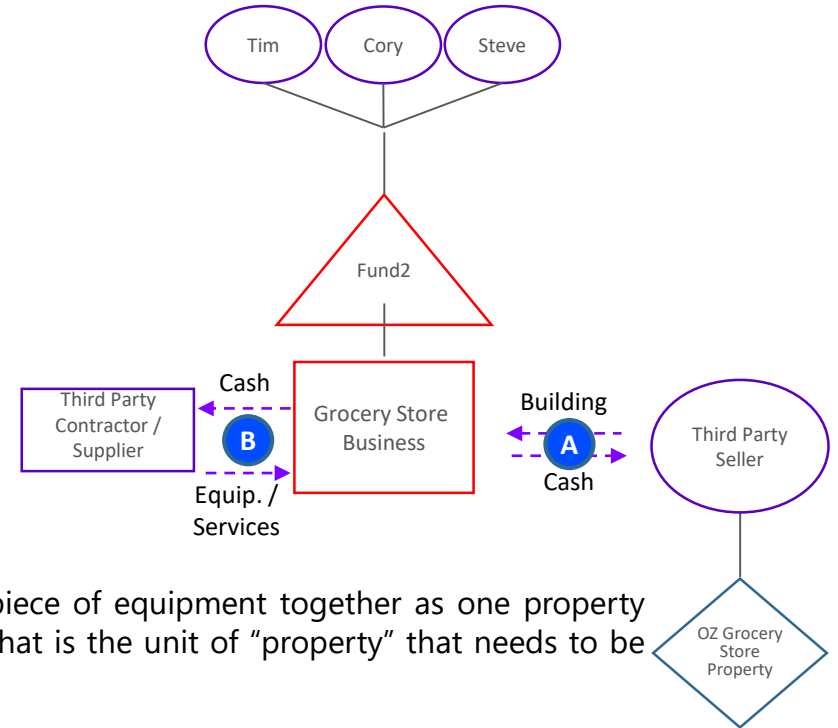
**Step 4: B** The Grocery Store Business spends \$40 renovating and expanding the building, and updating some of the equipment.

### **IRS Clarifications Needed**

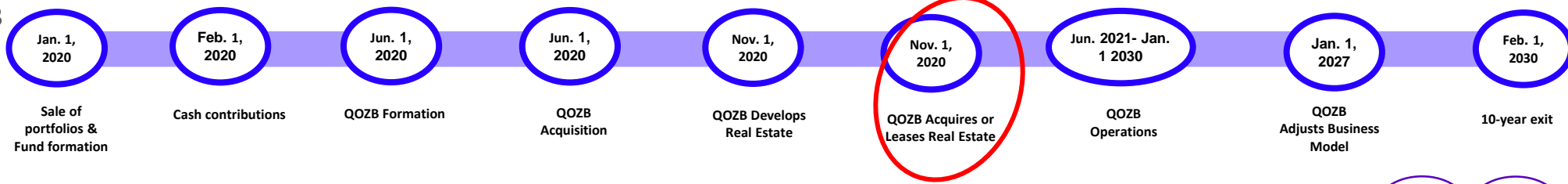
**Issue 33:** Is the Grocery Store Business required to substantially improve the acquired building and each piece of equipment together as one property whose aggregate basis needs to be doubled, or are the building and equipment considered separately? What is the unit of "property" that needs to be substantially improved per the 70% test?

### **Existing Clarifications**

**Clarification 33:** "[P]roperty has been substantially improved when the additions to basis of the property . . . exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period." Final Reg. 1.1400Z2(d)-2(b)(4)(i). Under an aggregation approach, "[t]he cost of purchased property that would otherwise qualify as qualified opportunity zone business property may be taken into account in determining whether additions to the basis of the non-original use property acquired by purchase satisfy the substantial improvement requirement under section 1400Z-2(d)(D)(ii), so long as the purchased property is" located in the same or contiguous a Opportunity Zone, used in the same trade or business, and improves the functionality of the non-original use property." Final Reg. 1.1400Z2(d)-2(b)(4)(iii)(A).



## Section 3



### **(New) Part 4: Existing Tangible Property**

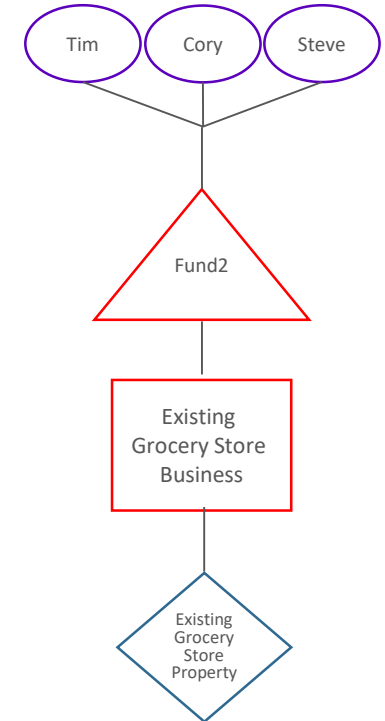
Assume Steps 1-2 and New Section 3 of Section 1 have occurred, the brothers sell their stock portfolios, form a QOF, contribute equity, and the QOF acquires an existing business that already operates in a QOZ.

**Step 4:** **C** The Grocery Store Business that Fund2 acquired from Tim (assume interests acquired by Fund2 are qualified opportunity zone stock) has owned its grocery store building in the QOZ since 2010 and uses equipment that the business acquired between 2010 and 2017. Fund2 will use its remaining capital to expand the store and update outdated equipment.

### **IRS Clarifications Needed**

**Issue 34:** Does an existing business that is acquired by a QOF which already owns tangible property need to acquire substantially all new property in order to meet the requirement that substantially all of its tangible property be acquired by purchase after December 31, 2017? Does the requirement apply if all of the business's tangible property is leased?

**Issue 35:** Does an existing business that is acquired by a QOF and already owns tangible property need to substantially improve substantially all of its existing property? What about if its tangible property is leased?

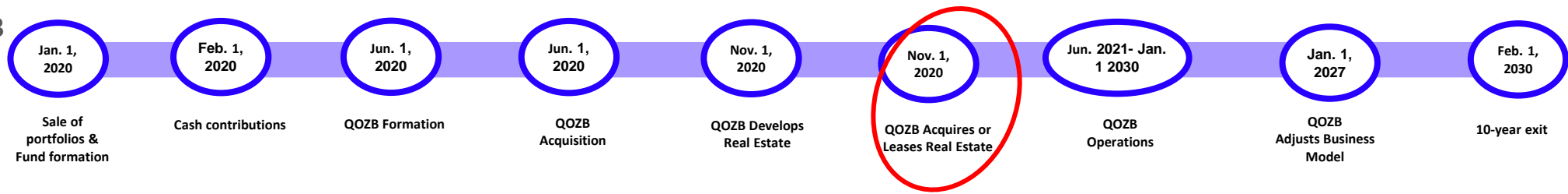


### **Existing Clarifications**

**Clarification 34:** A pre-existing entity "must satisfy all of the requirements of section 1400Z-2(d)(2)" and the applicable sections of the Final Regulations. Final Reg. 1400Z2(d)-1(a)(1)(iii). The regulations do not provide exceptions for the requirement that property be purchased after December 31, 2017. Where the QOZB's tangible property is leased, the lease must be "entered into after December 31, 2017." Final Reg. 1.1400Z2(d)-2(c)(1).

**Clarification 35:** As stated above, pre-existing entities are not exempt from the QOZBP requirements. In terms of leased property, the regulations generally provide that property does not have to be originally used or substantially improved, unless the lease is between the QOZB and a related party. Then, either: (1) the original use of tangible personal property must commence with the QOZB or (2) the QOZB must "become[] the owner of tangible property that is [QOZBP] having a value not less than the value of that leased tangible personal property" within the term of the lease or 30 months, whichever is earlier. Final Reg. 1.1400Z2(d)-2(c)(3).

## Section 3



### **(New) Part 4: Existing Tangible Property (cont.)**

Assume Steps 1-2 and New Section 3 of Section 1 have occurred, except the existing business does not operate in a QOZ.

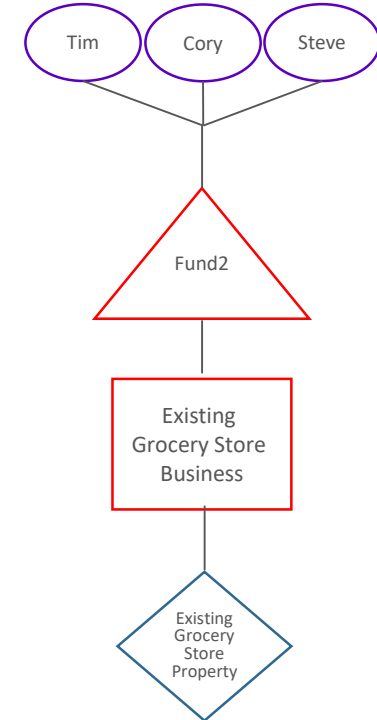
Step 4: **D** The Grocery Store Business that Fund2 acquired from Tim is currently located outside of the QOZ. Fund2 acquires the business and relocates the business into the QOZ where it acquires a building, but brings its existing equipment.

### **IRS Clarifications Needed**

Issue 36: If an existing business relocates into a QOZ and brings used equipment, can the equipment be deemed to be acquired after December 31, 2017 and in its "original use" in a QOZ if newly placed in service in a QOZ?

### **Existing Clarifications**

Clarification 36: "Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone." Final Reg. 1.1400Z2(d)-2(b)(3)(i)(C).





---

---

# IIC. Section 4:

## QOZB Adjusts Business Model

## Section 4



### **Part 6: Possible Changes to the Business Model**

**Step 6** **A** The brothers consider whether a plot of land outside of the QOZ (but still accessible to the Workforce Housing Development) would be better suited for the Grocery Store Business. Relocation makes economic sense, but the brothers do not want the Grocery Store Business to lose its status as a QOZB. The brothers are considering physically relocating to the land.

### **IRS Clarifications Needed**

**Issue 37:** Is the Grocery Store Business still a QOZB if it moves all of its tangible property outside of a QOZ after five years (see IRC Section 1400Z-2(d)(3)(B))? What about if the brothers relocate the Grocery Store Business to outside of the QOZ after only one year? If all of the business's tangible assets are located outside of a QOZ, does the business need to demonstrate that it has operations within a QOZ in order to maintain its QOZB status?

**Issue 38:** If the Grocery Store Business's tangible property remains in a QOZ, is there any issue with a majority of the business's revenue being sourced from outside of a QOZ? If the source of revenue matters for a QOZB, how is sourcing determined? For example, would the Grocery Store Business look at the point of sale and, if so, what if the sales are online? Would the Grocery Store Business look at the point of delivery?

### **Existing Clarifications**

**Clarifications 37-38:** The proposed regulations provide three "safe harbors" and a facts and circumstances test through which a QOZB can comply with the IRC Section 1397C(b)(2) gross income requirement. First, a majority of "services performed for the trade or business are performed" in the QOZ, based on hours performed. Second, a majority of the "services performed for the trade or business are performed" in the QOZ, based on amounts paid by the entity for services. Third, "the tangible property of the trade or business located in a [QOZ] and the management or operational functions performed in the [OZ] are each necessary for generation of at least 50 percent of the gross income of the trade or business." Fourth, a majority of the QOZB's gross income is "derived from the active conduct of a trade or business in" the QOZ based on the facts and circumstances. Final Reg. 1.1400Z2(d)-1(d)(3)(i)(C).

## Section 4



### **Part 6: Possible Changes to the Business Model**

**Step 6:** **C** The brothers consider leasing the Grocery Store Business's excess land to the major employer that previously moved to their town. The major employer is willing to pay a premium in order to open an additional facility in close proximity to where many of its employees reside.

**Step 6:** **D** The brothers consider franchising their business name and model to entrepreneurs who are interested in opening grocery stores in low-income communities.

**Step 6:** **E** The brothers consider expanding the business and opening grocery stores in other QOZs that have limited access to fresh and healthy food. They open eight more grocery stores all located in QOZs. They then realize there is a nearby area in need of a grocery store, but the store would not be in a QOZ. The brothers consider opening a tenth grocery store outside of a QOZ.

### **IRS Clarifications Needed**

**Issue 39:** What is the definition of "active conduct of a trade or business" in an Opportunity Zones context? Would rental income count against the Grocery Store Business for purposes of the requirement that a majority of its total gross income be derived from its "active conduct"?

**Issue 40:** What does it mean for a "substantial portion" of a business's intangible property to be used in the "active conduct" of such business? Would the Grocery Store Business run afoul of this requirement if it proceeds to franchise its business? Would it matter if the franchisees only opened grocery stores in QOZs?

**Issue 41:** Would the Grocery Store Business be able to change its capital structure, for example becoming publicly traded, without negatively impacting the QOF, provided that the QOF did not redeem their investment?

### **Existing Clarifications**

**Clarification 39:** A QOZB's "ownership and operation" of real property constitutes "active conduct." This includes leasing real property, but not triple-net-leasing. Final Reg. 1.1400Z2(d)-1(d)(3)(iii). So long as a majority of the Grocery Store Business's gross income is derived from its rental income of the land located in a QOZ and other qualifying sources (and the lease is not a triple-net-lease), then the Business should be in compliance with the gross income requirement. See Final Reg. 1.1400Z2(d)-1(d)(3)(i). See also Clarification 27 for the meaning of "trade or business" and Clarification 38 for the gross income requirement safe harbors.

**Clarification 40:** "[A] substantial portion of the intangible property of a [QOZB] must be used in the active conduct of a trade or business in a qualified opportunity zone. The term "substantial portion" means "at least 40 percent" in the context of the intangible property requirement. Intangible property is considered "used in the active conduct of a trader or business in a qualified opportunity zone if– (1) The use of the intangible property is normal, usual, or customary in the conduct of the trade or business; and (2) The intangible property is used in the qualified opportunity zone in the performance of an activity of the trade or business that contributes to the generated of gross income from the trade or business." Final Reg. 1.1400Z2(d)-1(d)(3)(ii).



---

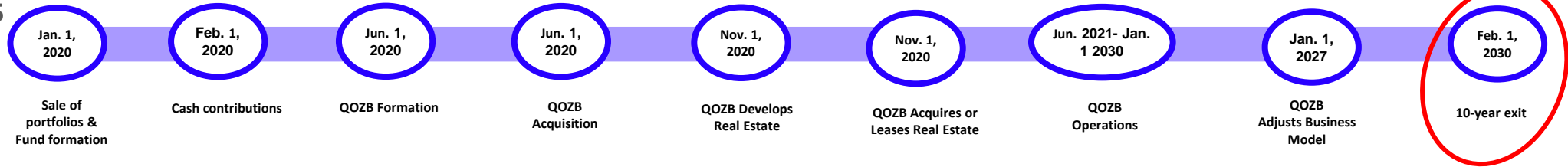
---

# IIC. Section 5:

## Sale of Fund Interests



## Section 5



### **Part 7: Sale of the Fund Interests**

**Step 7: A** After holding partnership interests in Fund2 for ten years and expanding access to fresh and healthy food in the QOZ, the brothers decide to sell Fund2 to the major employer that moved to their town. The major employer intends to continue operating and expanding the Grocery Store Business in order to continue providing accessible healthy food to its employees and others.

Assume Steps 1-6 have occurred, but the brothers want to exit the Grocery Store Business in 2025 instead of 2030.

**(New) Step 7: B** In 2025 the brothers receive an offer for the Grocery Store Business from the major employer that moved to their town. They decide to accept the offer. Rather than selling Fund2 to the employer, they sell the Grocery Store Business to the employer for a profit. The brothers remain invested in Fund2 and evaluate options for reinvestment into QOZP.

### **IRS Clarifications Needed**

**Issue 42:** In the scenario where Fund2 sells the Grocery Store Business in year five, how much time does Fund2 have to reinvest into other QOZP? Is there a grace period for reinvestment within the QOF or is the 90% requirement applied as usual? Does the sale of QOZP impact how the brothers will ultimately calculate whether they have been invested in a QOF for at least ten years? Would Fund2 need to reinvest only the principal, or the principal and the return? If Fund2 does not distribute cash from the grocery business sale and reinvests the money, will it need to pay tax from the sale?

### **Existing Clarifications**

**Clarification 42:** The QOF has 12 months from the date it “receives proceeds from the return of capital or the sale or disposition of some or all” of its QOZP to reinvest some or all of those proceeds into QOZP, so long as the proceeds are “continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less.” If the reinvestment takes longer than 12 months due to government inaction on an application that was timely completed, “that delay does not cause a failure of the 12-month requirement.” Additionally, if reinvestment “is delayed due to a Federally declared disaster . . . The QOF may receive up to an additional 12 months to reinvest such proceeds, provided that the QOF invests such proceeds in the manner originally intended before the disaster.” Final Reg. 1.1400Z2(f)-1(b). The regulations do not provide relief for QOFs or their investors to avoid recognizing gain on the sale or disposition of assets prior to a 10-year holding period.



---

---

# Appendix I for Part I:

Compiled Lists of IRS Clarifications Needed & Existing  
Clarifications for Workforce Housing Vignette

# Compiled Lists of IRS Clarifications Needed & Existing Clarifications

Issue 1: What types of gains may be invested in Opportunity Funds?

Clarification 1: Gains eligible for deferral must : (i) be “treated as a capital gain for Federal income tax purposes or is a qualified 1231 gain” (ii) otherwise be recognized before January 1, 2027 for Federal income tax purposes, and (iii) not arise from a sale or exchange with a person that is “related” to the taxpayer that recognizes or would recognize the gain within the meaning of IRC Section 1400Z-2(e)(2). Final Reg. 1.1400Z2(a)-1(b)(11)(i).

Issue 2: Will deferred gains recognized in 2026 have the same character and be subject to the same rate as when the deferral period began?

Clarification 2: If a taxpayer is required to include in income previously deferred gain, the gain so included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred. These attributes include those taken into account by sections 1(h), 1222, 1256, and any other applicable provisions of the IRC. The gain so included is subject to the Federal income tax provisions and rates that apply to other gains realized and recognized in the inclusion year. Final. Reg. 1.1400Z2(a)-1(c)(1).

Issue 3: How does an entity become an Opportunity Fund?

Clarification 3: An entity classified as a corporation or partnership for Federal tax purposes that is eligible to be an Opportunity Fund self-certifies as an Opportunity Fund. Final Reg. 1.1400Z2(d)-1(a)(1)(i). The IRS has released Form 8996 for entities to self-certify. This form requires the entity to verify, among other things, that it is (i) either a corporation or partnership, (ii) “organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund),” and (iii) the entity’s organizing documents will include the statement of purpose in (ii) and describe the entity’s qualified opportunity zone business by the end of the entity’s “first qualified opportunity fund year.” The form is also used to verify annually that the entity meets the 90% Test or figure the penalty if the entity fails to meet the 90% Test. See IRS Form 8996 & instructions. In October 2019 the IRS released a new draft Form 8996 for the 2019 taxable year, which would also require reporting on the QOF’s holdings of Qualified Opportunity Zone Business Property and Qualified Opportunity Zone Business stock or partnership interests.

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 4: Can either 3RE (Option 3A-1) or each 3RE partner (Option 3A-2) be the “taxpayer” that makes the investment into an Opportunity Fund?

Clarification 4: A partnership may elect to defer recognition of its eligible gains. If it does not elect to defer its eligible gains, the gains are included in the partners’ distributive shares under IRC section 702. If a partner’s distributive share includes eligible gains, the partner may elect to defer those gains. The 180-day period with respect to the partner’s eligible gains in the partner’s distributive share generally begins on the last day of the partnership taxable year in which the partner’s allocable share is taken into account under IRC section 706(a). However, generally the partner may elect to treat its own 180-day period as being the same as the partnership’s 180-day period or as beginning on the original due date for the partnership’s tax return for the taxable year in which the partnership realized the gain. Final Reg. 1.1400Z2(a)-1(c)(7)-(8).

Issue 5: How much cash is an Opportunity Zone Business (i.e., Business) permitted to have as “reasonable” working capital?

Clarification 5: Working capital is treated as reasonable in amount if: (i) the amounts are “designated in writing for the development of a trade or business in a qualified opportunity zone . . . , including when appropriate the acquisition, construction, and/or substantial improvement of tangible property” in an Opportunity Zone, (ii) “[t]here is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets,” and working capital is spent within 31 months of receipt under the schedule, and (iii) “the working capital assets are actually used in a manner that is substantially consistent” with the plan and schedule. Final Reg. 1.1400Z2(d)-1(d)(3)(v).

Issue 6: What kinds of interests may investors receive in Opportunity Funds for their investments?

Clarification 6: An “eligible interest” in an Opportunity Fund is an “equity interest” issued by the Opportunity Fund, “including preferred stock or a partnership interest with special allocations.” Debt interests do not qualify. Final. Reg. 1.1400Z2(a)-1(b)(12). “A taxpayer makes an investment in a QOF by transferring cash or other property to a QOF.” Services rendered to a QOF are not considered the making of a qualifying investment. Thus, “if a taxpayer receives an eligible interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is not a [qualifying investment]....” Final Reg. 1.1400Z2(a)-1(c)(5).

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 7: When does Fund qualify as an Opportunity Fund? When must Fund satisfy the 90% Test?

Clarification 7: An entity must identify the first taxable year to be an Opportunity Fund on its self-certification. It may also identify the first month to be an Opportunity Fund. Opportunity Funds are subject to the requirement that they hold at least 90% of their assets in certain eligible property, measured on certain dates throughout the Opportunity Fund's taxable year (the "90% Test"). IRC section 1400Z-2(d)(1). The first testing date is the earlier of (i) the last day of the first 6 months each of which is in the taxable year and in each of which the entity is an Opportunity Fund and (ii) the last day of the taxable year. Final Reg. 1.1400Z2(d)-1(a)(2). On each testing date, the Opportunity Fund may choose to disregard property contributed to the QOF within the previous 6 months, so long as the property received by the QOF solely as a contribution or in exchange for stock and beginning on the fifth business day after the contribution or exchange the property is "held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less." Final Reg. 1.1400Z2(d)-1(b)(2)(B).

Issue 8: If Opportunity Funds (i.e., Fund) and Opportunity Zone Businesses (i.e., Business) borrow money, will debt allocated to the Opportunity Fund's partners cause all or a portion of their investments to be non-qualifying?

Clarification 8: The deemed contribution of money resulting from an increase in a partner's share of liabilities of a partnership under IRC section 752(a) does not create or increase an investment with mixed funds described in IRC Section 1400Z-2(e)(1). Final Reg. 1.1400Z2(a)-1(f)(2).

Issue 9: Is substantial improvement of the OZ Street Property measured with respect to the land (i.e., requiring improvements at least equal to the total acquisition cost allocated to land, or \$100) or the existing buildings (i.e., requiring improvement at least equal to the total acquisition cost allocated to the buildings, or \$180) or both (i.e., improvements at least equal to the total acquisition cost of \$280)?

Clarification 9: If an Opportunity Fund purchases a building wholly within an Opportunity Zone, under IRC section 1400Z-2(d)(2)(D)(ii), a substantial improvement to the building is measured by the Opportunity Fund's additions to the adjusted basis of the building. A substantial improvement to the building does not require the Opportunity Fund to separately substantially improve the land on which the building is located. Rev. Rul. 2018-29 and Final Reg. 1.1400Z2(d)-2(b)(4)(iv).

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 10: Will property be treated as substantially improved even if the improvements are not complete?

Clarification 10: If working capital is reasonable because of compliance with the safe harbor (see Clarification 5), and if the tangible property is expected to become substantially improved as a result of spending the working capital, then that property is treated as Opportunity Zone Business Property during the working capital periods. Final Reg. Sec. 1.1400Z2(d)-1(d)(3)(viii). Additionally, tangible property may benefit from multiple applications of the safe harbor for a total of 62-months. Final Reg. 1.1400Z2(d)-1(d)(3)(v)(F).

Issue 11: What percentage of Business' property needs to be Opportunity Zone Business Property? How is this calculated?

Clarification 11: Substantially all of the tangible property owned or leased by an Opportunity Zone Business must be Opportunity Zone Business Property. A trade or business of an entity is treated as satisfying the substantially all requirement if at least 70 percent of the tangible property owned or leased by the trade or business is "qualified opportunity zone business property." If the entity has an "applicable financial statement" within the meaning of IRC section 1.475(a)-4(h), then Business may calculate compliance with the 70 percent requirement by using the value of each asset of the entity as reported on the financial statement for the relevant reporting period. Alternatively, the "value of tangible property owned . . . is the unadjusted cost basis of the property under section 1012" and the "value of tangible property that is leased . . . is equal to the present value of the leased tangible property." Final Reg. 1.1400Z2(d)-1(b)(2)(ii)(A) and 1.1400Z2(d)-1(b)(4).

Issue 12: Will the lapse of Opportunity Zone status in 2028 prevent 3RE and Sara from receiving the benefits of holding Fund interests for 10 years?

Clarification 12: "The ability to make an election . . . for investments held for at least 10 years is not impaired solely because, under 1400Z-1(f), the designation of one or more [Opportunity Zones] ceases to be in effect." Final Reg. 1.1400Z2(c)-1(c).

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 13: Assuming Fund has already qualified as an Opportunity Fund by August 2019, does the purchase by Sara of the equity interests in the Fund qualify as an investment for purposes of the 180-day requirement?

Clarification 13: A taxpayer can make an investment in an Opportunity Fund for purposes of the 180-day requirement “by acquiring . . . an eligible interest in a QOF from a person other than the QOF.” Final Reg. 1.1400Z2(a)-1(c)(6)(iv).

Issue 14A: Is the distribution in Step 7C considered a sale or exchange such that 3RE is required to recognize the \$80 of gain reinvested in Step 5A?

Clarification 14A: “An actual or deemed distribution of property, including cash, by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event,” meaning gain equal to the distribution must be recognized, “only to the extent that the distributed property has a fair market value in excess of the partner’s basis in the qualifying investment.” Final Reg. 1.1400Z2(b)-1(c)(6)(iii). Under certain circumstances, the transfer to the partnership will not be treated as a qualifying investment to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution would be recharacterized as a disguised sale under IRC Section 707 if “(i) any cash contributed were non-cash property, and (ii) in the case of a distribution by the partnership to which §1.707-5(b) (relating to debt-financed distributions) applies, the partner’s share of liabilities is zero.” Final Reg. 1.1400Z2(a)-1(c)(6)(iii).

Issue 14B: If the lender required personal guarantees from Sara and the partners of 3RE would that create a “mixed investment” under the IRC?

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 15: Will Fund be treated as never having been an Opportunity Fund, cease to be an Opportunity Fund, or will it incur a penalty for each month it fails to qualify?

Clarification: To the extent that “consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete,” such delay would not be considered a failure to spend the working capital “substantially consistently” with its written plan and schedule within 31 months. Final Reg. 1.1400Z2(d)-1(d)(3)(v)(C). Additionally, if an Opportunity Zone Business is located in an Opportunity Zone “within a Federally declared disaster (as defined in section 165(i)(5)(A)),” then it “may receive up to an additional 24 months to consume its working capital assets.” Final Reg. 1.1400Z2(d)-1(d)(3)(v)(D). The Preamble to the Final Regulations notes that if an Opportunity Zone Business “fails to satisfy the conditions for applying a 31-month working capital safe harbor” and cannot satisfy the requirements to be an Opportunity Zone Business without the safe harbor then “such failure could cause a[n] [Opportunity Fund] to fail to satisfy the 90-percent investment standard, which would result in penalties.” TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(D)-1, O, 5.

Issue 16: If Fund incurs a penalty, how would the penalty be calculated? For how long may Fund fail to qualify before it loses Opportunity Fund status altogether, if ever?

Clarification 16: If a Fund “fails to satisfy the 90-percent asset investment standard . . . then the [fund] must pay the statutory penalty set forth in section 1400Z-2(f) for each month it fails to meet the 90-percent asset investment standard.” Final Reg. 1.1400Z2(f)-1(a). The Preamble to the Final Regulations provides that “the Treasury Department and the IRS continue to consider the circumstances under which involuntary decertification of a QOF would be warranted, and intend to propose guidance regarding those circumstances.” TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(d)-1, A, 3.

Issue 17: If Fund failed to qualify as an Opportunity Fund, would 3RE and Sara still be entitled to the deferral of their gains until the end of the 31-month period?



## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 18: Will there be a grace period for Fund/Business to reinvest the proceeds from Step 7A into Opportunity Zone Business Property before needing to meeting the 90% Test?

Clarification 18: The Fund has a “12-month period beginning on the date of the distribution, sale, or disposition” of Opportunity Zone Business Property to reinvest the proceeds into Opportunity Zone Business Property, so long as the proceeds “are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less.” If there is a delay in reinvestment due to “waiting for government action the application for which is complete, that delay does not cause a failure of the 12-month requirement.” If reinvestment by an Opportunity Fund “is delayed due to a Federally declared disaster,” then the Opportunity Fund “may receive up to an additional 12 months to reinvest such proceeds, provided that the [Opportunity Fund] invests such proceeds in the manner originally intended before the disaster.” Final Reg. 1.1400Z2(f)-1(b).

Issue 19: Will 3RE and Sara be relieved from immediate taxation when Fund sells property and reinvests the proceeds into Opportunity Zone Property?

Clarification 19: There are currently no regulations permitting QOFs or their investors to avoid recognizing gain on the sale or disposition of assets before holding a QOF investment for at least 10 years.

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 20: Do debt-financed gains realized by 3RE and Sara qualify for the benefits?

Issue 21: If Fund sells the OZ Street Property (i.e. Option B), does gain allocated to 3RE and Sara from that sale qualify for the benefits, or are the benefits only available in Option A?

Clarification 21: "If a taxpayer has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years . . . and the QOF partnership or QOF S corporation or any partnership that is owned, directly, or indirectly solely through one or more partnerships, by the QOF partnership or QOF S corporation disposes of the property, the taxpayer may make an election . . . to exclude from the taxpayer's income all gains and losses allocable to the qualifying investment that arise from all such sales or exchanges for the QOF partnership's or QOF S corporations taxable year." Final Reg. 1.400Z2(c)-1(b)(2)(ii)(A).

Issue 22: Will the portion of 3RE and Sara's gain attributable to depreciation recapture qualify for the benefits?

Clarification 20 & 22: When a partner in a Fund makes an IRC 1400Z-2(c) election after ten years to adjust its basis to fair market value, "the basis of the QOF partnership interest is adjusted to an amount equal to the fair market value of the interest, plus the QOF partner's share of QOF partnership indebtedness under section 752 with respect to that interest, and immediately prior to the sale or exchange, the bases of the assets of the QOF partnership and of any partnership owned directly or indirectly by the QOF partnership solely through one or more partnerships are also adjusted with response to the disposed-of qualifying investment." These adjustments are calculated in a manner similar to the section 743(b) adjustments that would have been made if the transferor QOF partner purchased its interest in the QOF partnership for cash equal to the fair market value immediately prior to the sale or change, assuming that valid section 754 elections had been in place with respect to the QOF partnership and any partnerships directly or indirectly owned by the QOF partnership, whether or not an actual section 754 election is in place for any of the partnerships." Final Reg. 1.400Z2(c)-1(b)(2)(i).



---

---

# Appendix II for Part III:

Compiled Lists of IRS Clarifications Needed & Existing Clarifications for the Grocery Store Vignette

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications

Issue 23: Does it matter where a new business is organized for the purpose of being a QOZB (e.g., can a QOZB can be incorporated in Delaware or Puerto Rico)?

Clarification 23: An entity must be “organized under the law of the United States or one of the 50 states, a government of a Federally recognized tribe (Indian tribal government), the District of Columbia, or a U.S. territory” in order to qualify as a QOZB. “If an entity is organized in a U.S. territory but not in one of the 50 States or the District of Columbia,” the entity can only be a QOZB “if the entity conducts a qualified opportunity zone business in the U.S. territory in which the entity is organized.” Final Reg. 1.1400Z2(d)-1(a)(1)(ii).

Issue 24: Can a QOZB be an LLC? Can a QOZB be a disregarded entity for tax purposes?

Clarification 24: Interests in an entity can be qualified opportunity zone stock or qualified opportunity zone partnership interests if such entity is “classified as a corporation or partnership for Federal tax purposes.” Final Reg. 1.1400Z2(d)-1(a)(1)(i). The Preamble to the Final Regulations states that “transparent entities”, such as a qualified subchapter S subsidiary, a grantor trust, or an entity disregarded as separated from the QOF” will not be “treated as a qualified opportunity zone business in which the QOF has invested.” TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(d)-1, B, 1..

Issue 25: In order to fall within the QOZB “safe harbor for reasonable amount of working capital” described in Clarification 5, how specific do the written plan and schedule need to be?

Clarification 25: The schedule must be “consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets.” Final Reg. 1.1400Z2(d)-1(c)(3)(v)(B). An example states that a QOZB with a plan and schedule specifying the following met the safe harbor: “[o]f the \$w million, \$x million was dedicated to the land purchase, \$y million to the construction of the building, and \$z million to ancillary but necessary expenditures for the project. The written plans provided for the purchase of the land within a month of receipt of the cash from QOF T and for the remaining \$y and \$z million to be spent within the next months on construction of the building and on the ancillary expenditures.” Final Reg. 1.1400Z2(d)-1(c)(v)(G)(3). There does not appear to be further guidance on the specificity required for the schedule and plan.

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 26: During the period before the Grocery Store Business became profitable, was the business in compliance with the IRC Section 1397C(b)(2) requirement that a majority of its total gross income be derived from its active conduct? What does it mean to be a “trade or business” with “active conduct” in the QOZ context?

Clarification 26: If financial property is “treated as being a reasonable amount of working capital” because of compliance with the requirements for the “safe harbor for reasonable amount of working capital” then “[s]olely for purposes of applying the 50-percent test in section 1397C(b)(2) to the definition of a qualified opportunity zone business in section 1400Z-2(d)(3), if any gross income is derived from property” that the safe harbor “treats as a reasonable amount of working capital, then that gross income is counted toward satisfaction of the 50-percent test.” Final Reg. 1.1400Z2(d)-1(d)(3)(vi). Otherwise, the proposed regulations do not specify whether a business without income can satisfy the gross income requirement, but do provide safe harbors and a facts and circumstances test for determining whether a business’s income is sufficiently derived from its active conduct in a QOZ. See Clarification 37. The term “trade or business” is defined through reference to IRC Section 162, which delineates allowable deductions for trade or business expenses. Final Reg. 1.1400Z2(d)-1(d)(1).

Issue 27: Once the Grocery Store Business is profitable in June 2022, can it distribute those interim profits to Fund2 and out to the brothers? Is there a risk that such distributions would be considered a redemption instead of a return on investment? Does the amount of the distribution in “excess of basis” matter?

Clarification 27: A QOF partnership’s “actual or deemed distribution of property, including cash” will be considered a redemption (also known as an “inclusion event”) “to the extent that the distributed property has a fair market value in excess of the partner’s basis in its qualifying investment.” Final Reg. 1.1400Z2(b)-1(c)(6)(iii). See also Clarification 14A and Example 10 of Final Reg. 1.1400Z2(b)-1(f), where a partner was not required to recognize gain on a distribution from a QOF partnership to the extent of the partner’s basis (including debt allocations under IRC 752) in the partnership.

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 28: Can the QOZB accumulate cash instead of distributing or reinvesting? Would increasing cash reserves not earmarked for deployment run afoul of the IRC Section 1397C(b)(8) limit on nonqualified financial property and the carve-out for working capital? How is “working capital” defined in a QOZB context after a reserve is built?

Clarification 28: The safe harbor for working capital allows for working capital assets to be held not only for the acquisition and development of tangible property, but also more generally for business development. Final Reg. 1.1400Z2(d)-1(d)(3)(v)(A). The regulations do not provide specific guidance on working capital accumulated from revenue outside of the safe harbor period.

Issue 29: At what point is a store’s sale of alcoholic beverages for consumption off premises considered to be the store’s “principal business”? At what point does selling lottery tickets mean that a store is a “facility used for gambling”? What percentage of revenue must be attributable to an activity for the activity to be considered the “principal business” and over what time period is this percentage tested? Is the percentage tested at the store level or the business level (i.e., if the Grocery Store Business owns multiple grocery stores)?

Clarification 29: “De minimis amounts of gross income attributable to a business described in section 144(c)(6)(B),” which are “sin businesses” such as liquor stores and gambling facilities, “will not cause a trade or business to fail to be a qualified opportunity zone business.” “The term de minimis amount of gross income . . . means less than 5 percent of the gross income of the qualified opportunity zone business may be attributable to the type of business described in section 144(c)(6)(B).” Final Reg. 1.1400Z2(d)-1(d)(4)(ii)-(iii). In addition to the limitation on operating a “sin business,” a QOZB also cannot lease “more than a de minimis amount of property” to a “sin business.” Final Reg. 1.1400Z2(d)-1(d)(4)(i). In this context “de minimis” is defined as “less than 5 percent of the net rentable square feet for real property and less than 5 percent of the value of all other tangible property.” Final Reg. 1.1400Z2(d)-1(d)(4)(iii).

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 30: Can a pre-existing entity be a QOZB?

Clarification 30: "There is no legal barrier to a pre-existing eligible entity qualifying as a QOF or a qualified opportunity zone business, but the pre-existing eligible entity must satisfy all of the applicable requirements of section 1400Z-2" and the Final Regulations. Final Reg. 1400Z2(d)-1(a)(1)(iii).

Issue 31: Can equity interests acquired by a QOF from a business' existing equity owners qualify as qualified opportunity zone stock or qualified opportunity zone partnership interests?

Clarification 31: Qualified opportunity zone stock must be acquired by a QOF "at its original issue (directly or through an underwriter) from the corporation" and qualified opportunity zone partnership interests must be acquired "from the partnership." IRC 1400Z-2(d)(2)(B)-(C).

Issue 32: What are the consequences if the brothers are unable to execute on the business plan and pull their money out of Fund2 after two years? Do the brothers receive the benefit of a two year deferral because of their good faith effort to properly invest in a QOF and acquire QOZP? If so, what is required to show good faith? If the brothers should not have received the benefit of the two year deferral despite their good faith efforts, are they penalized for underpaying their taxes?

Issue 32: The Final Regulations provide a 6-month cure period for qualified opportunity zone business, under which "the QOF may treat the stock or partnership interest in that business as qualified opportunity zone property for that semiannual testing date provided the business corrects the failure within 6 months of the date on which the stock or partnership interest lost its qualification." A QOF is only allowed to benefit from one six-month cure period. Final Reg. 1.1400Z2(d)-1(d)(6). Per the Preamble to the Final Regulations, "in addition to this six-month cure period, a QOF can assert a defense of reasonable cause under section 1400Z-2(f)(3)." TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(d)-1, G, 6. In terms of what constitutes "reasonable cause," the Treasury and IRS direct taxpayers to "the general standards set out in the 'Penalty Handbook,' which is included in Internal Revenue Manual (IRM) at section 20.1." TD 9889, Comments Not Specifically on Regulatory Text, F. The Preamble also provides that "the Treasury Department and the IRS continue to consider the circumstances under which involuntary decertification of a QOF would be warranted, and intend to propose guidance regarding those circumstances." TD 9889, Comments and Changes to Prop. Sec. 1.1400Z2(d)-1, A, 3.

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 33: Is the Grocery Store Business required to substantially improve the acquired building and each piece of equipment together as one property whose aggregate basis needs to be doubled, or are the building and equipment considered separately? What is the unit of “property” that needs to be substantially improved per the 70% test?

Clarification 33: “[P]roperty has been substantially improved when the additions to basis of the property . . . exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period.” Final Reg. 1.1400Z2(d)-2(b)(4)(i). Under an aggregation approach, “[t]he cost of purchased property that would otherwise qualify as qualified opportunity zone business property may be taken into account in determining whether additions to the basis of the non-original use property acquired by purchase satisfy the substantial improvement requirement under section 1400Z-2(d)(D)(ii), so long as the purchased property is” located in the same or contiguous a Opportunity Zone, used in the same trade or business, and improves the functionality of the non-original use property.” Final Reg. 1.1400Z2(d)-2(b)(4)(iii)(A).

Issue 34: Does an existing business that is acquired by a QOF which already owns tangible property need to acquire substantially all new property in order to meet the requirement that substantially all of its tangible property be acquired by purchase after December 31, 2017? Does the requirement apply if all of the business’s tangible property is leased?

Clarification 34: A pre-existing entity “must satisfy all of the requirements of section 1400Z-2(d)(2)” and the applicable sections of the Final Regulations. Final Reg. 1400Z2(d)-1(a)(1)(iii). The regulations do not provide exceptions for the requirement that property be purchased after December 31, 2017. Where the QOZB’s tangible property is leased, the lease must be “entered into after December 31, 2017.” Final Reg. 1.1400Z2(d)-2(c)(1).



## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 35: Does an existing business that is acquired by a QOF and already owns tangible property need to substantially improve substantially all of its existing property? What about if its tangible property is leased?

Clarification 35: As stated above, pre-existing entities are not exempt from the QOZBP requirements. In terms of leased property, the regulations generally provide that property does not have to be originally used or substantially improved, unless the lease is between the QOZB and a related party. Then, either: (1) the original use of tangible personal property must commence with the QOZB or (2) the QOZB must “become[] the owner of tangible property that is [QOZBP] having a value not less than the value of that leased tangible personal property” within the term of the lease or 30 months, whichever is earlier. Final Reg. 1.1400Z2(d)-2(c)(3).

Issue 36: If an existing business relocates into a QOZ and brings used equipment, can the equipment be deemed to be acquired after December 31, 2017 and in its “original use” in a QOZ if newly placed in service in a QOZ?

Clarification 36: “Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone.” Final Reg. 1.1400Z2(d)-2(b)(3)(i)(C).

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 37: Is the Grocery Store Business still a QOZB if it moves all of its tangible property outside of a QOZ after five years (see IRC Section 1400Z-2(d)(3)(B))? What about if the brothers relocate the Grocery Store Business to outside of the QOZ after only one year? If all of the business's tangible assets are located outside of a QOZ, does the business need to demonstrate that it has operations within a QOZ in order to maintain its QOZB status?

Issue 38: If the Grocery Store Business's tangible property remains in a QOZ, is there any issue with a majority of the business's revenue being sourced from outside of a QOZ? If the source of revenue matters for a QOZB, how is sourcing determined? For example, would the Grocery Store Business look at the point of sale and, if so, what if the sales are online? Would the Grocery Store Business look at the point of delivery?

Clarifications 37-38: The proposed regulations provide three "safe harbors" and a facts and circumstances test through which a QOZB can comply with the IRC Section 1397C(b)(2) gross income requirement. First, a majority of "services performed for the trade or business are performed" in the QOZ, based on hours performed. Second, a majority of the "services performed for the trade or business are performed" in the QOZ, based on amounts paid by the entity for services. Third, "the tangible property of the trade or business located in a [QOZ] and the management or operational functions performed in the [OZ] are each necessary for generation of at least 50 percent of the gross income of the trade or business." Fourth, a majority of the QOZB's gross income is "derived from the active conduct of a trade or business in" the QOZ based on the facts and circumstances. Final Reg. 1.1400Z2(d)-1(d)(3)(i)(C).

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 39: What is the definition of “active conduct of a trade or business” in an Opportunity Zones context? Would rental income count against the Grocery Store Business for purposes of the requirement that a majority of its total gross income be derived from its “active conduct”?

Clarification 39: A QOZB’s “ownership and operation” of real property constitutes “active conduct.” This includes leasing real property, but not triple-net-leasing. Final Reg. 1.1400Z2(d)-1(d)(3)(iii). So long as a majority of the Grocery Store Business’s gross income is derived from its rental income of the land located in a QOZ and other qualifying sources (and the lease is not a triple-net-lease), then the Business should be in compliance with the gross income requirement. See Final Reg. 1.1400Z2(d)-1(d)(3)(i). See *also* Clarification 27 for the meaning of “trade or business” and Clarification 38 for the gross income requirement safe harbors.

Issue 40: What does it mean for a “substantial portion” of a business’s intangible property to be used in the “active conduct” of such business? Would the Grocery Store Business run afoul of this requirement if it proceeds to franchise its business? Would it matter if the franchisees only opened grocery stores in QOZs?

Clarification 40: “[A] substantial portion of the intangible property of a [QOZB] must be used in the active conduct of a trade or business in a qualified opportunity zone. The term “substantial portion” means “at least 40 percent” in the context of the intangible property requirement. Intangible property is considered “used in the active conduct of a trader or business in a qualified opportunity zone if– (1) The use of the intangible property is normal, usual, or customary in the conduct of the trade or business; and (2) The intangible property is used in the qualified opportunity zone in the performance of an activity of the trade or business that contributes to the generated of gross income from the trade or business.” Final Reg. 1.1400Z2(d)-1(d)(3)(ii). .

Issue 41: Would the Grocery Store Business be able to change its capital structure, for example becoming publicly traded, without negatively impacting the QOF, provided that the QOF did not redeem their investment?

## Compiled Lists of IRS Clarifications Needed & Existing Clarifications (Cont.)

Issue 42: In the scenario where Fund2 sells the Grocery Store Business in year five, how much time does Fund2 have to reinvest into other QOZP? Is there a grace period for reinvestment within the QOF or is the 90% requirement applied as usual? Does the sale of QOZP impact how the brothers will ultimately calculate whether they have been invested in a QOF for at least ten years? Would Fund2 need to reinvest only the principal, or the principal and the return? If Fund2 does not distribute cash from the grocery business sale and reinvests the money, will it need to pay tax from the sale?

Clarification 42: The QOF has 12 months from the date it “receives proceeds from the return of capital or the sale or disposition of some or all” of its QOZP to reinvest some or all of those proceeds into QOZP, so long as the proceeds are “continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less.” If the reinvestment takes longer than 12 months due to government inaction on an application that was timely completed, “that delay does not cause a failure of the 12-month requirement.” Additionally, if reinvestment “is delayed due to a Federally declared disaster . . . The QOF may receive up to an additional 12 months to reinvest such proceeds, provided that the QOF invests such proceeds in the manner originally intended before the disaster.” Final Reg. 1.1400Z2(f)-1(b). The regulations do not provide relief for QOFs or their investors to avoid recognizing gain on the sale or disposition of assets prior to a 10-year holding period..

# Contributors

## MILKEN INSTITUTE

---

**Aron Betru**  
Managing Director,  
Center for Financial Markets

**Chris Lee**  
Director, Center for Financial Markets

**Ragini Chawla**  
Associate, Center for Financial Markets

## KIRKLAND & ELLIS LLP

---

**William A. Levy**  
Partner, Tax Group

**Stephen G. Tomlinson**  
Partner, Real Estate

**Nicholas Warther**  
Associate, Tax Group



**Michael Bernier**  
Partner, National Tax  
Ernst & Young LLP

**Rachel Weiss van Deuren**  
Manager, National Tax  
Ernst & Young LLP