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U.S. Treasury's Second Round of Opportunity Zone Regulations

The U.S. Conference of Mayors provided comments in December 2018 on U.S. Treasury's first round of proposed regulations highlighting the need for revision to the 50% Gross Income Test; flexibility in the 31-month safe harbor for working capital given the delays inherent in larger capital projects; regulations that promote investment in QOZ operating businesses; and clarification that goods in transit or temporary storage are considered as used in the QOZ. Below is a summary of major provisions in the second round of proposed regulations, released April 17, 2019, that address these issues-- in most instances favorably.

From U.S. Treasury's Press Release

"Qualified opportunity zone business property is tangible property used in a trade or business of the QO Fund if the property was purchased after Dec. 31, 2017. The guidance permits tangible property acquired after Dec. 31, 2017, under a market rate lease to qualify as "qualified opportunity zone business property" if during substantially all of the holding period of the property, substantially all of the use of the property was in a qualified opportunity zone.

A key part of the newly released guidance clarifies the "substantially all" requirements for the holding period and use of the tangible business property:

- For use of the property, at least 70 percent of the property must be used in a qualified opportunity zone.
- For the holding period of the property, tangible property must be qualified opportunity zone business property for at least 90 percent of the QO Fund's or qualified opportunity zone business's holding period.
- The partnership or corporation must be a qualified opportunity zone business for at least 90 percent of the QO Fund's holding period."

50% Gross Income Test

The first round of regulations required that 50 percent of the gross income of the QOZ Business be derived from the active conduct of a trade or business *in the qualified opportunity zone*. The second round of regulations keep this 50% test, but provides three safe harbors any of one

which, if met, satisfies the Gross Income Test. In addition, the regulations provide for a facts and circumstances test if the safe harbors do not apply.

- At least 50 percent of the services performed by employees or independent contractors (based on hours) are performed in the QOZ;
- At least 50 percent of the amount paid for services are for services performed by employees or independent contractors in the QOZ; or
- The tangible property and management and operational functions needed to produce 50 percent of gross income are located in the QOZ.

The “facts and circumstances” test meets the Gross Income Test if, based on all the facts and circumstances, at least 50 percent of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ.

Working Capital Safe Harbor

The second round of regulations clarify that the 31 month working capital safe harbor applies to assets necessary for the operation of a qualified business. Previously, the regulations had stated that the safe harbor applied only to qualified opportunity zone businesses that acquire, construct or rehabilitate tangible business property, which includes both real property and other tangible property. This clarification will help QOFs invest in operating businesses.

- The working capital safe harbor now applies to the development of a trade or business in the QOZ thereby including operating businesses.
- A single QOZ Business can use multiple (overlapping or sequential) working capital funds, each with their distinct safe harbor, during a project. For example, on a major construction project, an OZ business could have a safe harbor working capital fund for site preparation, and another one for vertical construction. Again, Treasury’s intent is to bring OZ businesses flexibility in their efforts to invest in OZs.
- The regulations allow for the extension of the 31- month safe harbor for working capital. Under the previous proposed regulations, OZ businesses could hold funds for 31 months, but many cities and responders had indicated that securing environmental approvals and other permitting requirements for large projects may not be feasibly obtained within that timeframe. The new rules establish that the working capital safe harbor is not jeopardized if the delay is the result of failure to receive such approvals during the 31-month period as long as the application for such permits were made during that period.

Substantially All

The first set of regulations established that 70% or “substantially all” of the tangible assets of a QOZ business must be located in the Opportunity Zone. The second set of regulations confirmed the 70% substantially all test.

“Substantially all” appears elsewhere in the statute. Substantially all test is 70% for use in the QOZ requirement; but 90% for the holding period requirement to qualify as QOZ business property and QOF’s interest in a QOZ business.

Original Use of Vacant Property

If property has been unused or vacant for an uninterrupted period of at least five years, use of that property in the QOZ qualifies as original use.

Inventory in Transit

Inventory in transit or temporarily stored outside a QOZ will be considered used in the QOZ and not counted against the 90 percent asset test and proposed 70 percent substantially all test.

Leased Property

The second round of regulations allow leased tangible property to be treated as QOZ Business Property for purposes of meeting the 90-percent asset test and 70-percent substantially all test.

The following, however, apply.

- No original use requirement exists for leased property.
- The lease must be a “market rate lease” determined under arm’s length principles.
- Leased property does not need to be acquired from an unrelated party. If the lessor and lessee are related:
 - No prepayment of rent is allowed exceeding one year.
 - Leased property is treated as QOZ Business Property only if its value is equal to the value of acquired/purchased QOZ Business Property.
- The regulations provide an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for real property other than unimproved land. If there was a plan to purchase the property for an amount other than fair market value at the time of purchase, the leased property is not QOZ Business Property.