



DUVAL & STACHENFELD LLP

# **The Key to QOZB Compliance – The Working Capital Safe Harbor**

## **D&S Road Map to Opportunity Zones**



**D&S Opportunity Zone Practice Group**  
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## 1. The Land of OZ (Opportunity Zones)

Navigating the Land of OZ can be tricky, especially at the outset of a project. The Opportunity Zone program (“OZ Program”) is chock full of requirements and deadlines, and every part of the structure has a different set of rules. For example:

- In order to claim the tax benefits associated with an opportunity zone investment, investors must invest the right type of eligible capital gain into a qualified opportunity fund (“QOF”) before their reinvestment period expires, and that reinvestment period can differ for each investor.<sup>1</sup>
- Then, a QOF has a certain amount of time to invest those gains into qualifying property in order to meet its own 90% asset test (the “QOF 90% Asset Test”), measured on specified testing dates.<sup>2</sup>
- Additionally, most QOFs invest in qualifying property indirectly through a qualified opportunity zone business (“QOZB”), and a QOZB has its own set of requirements that it must meet so that it qualifies as an eligible investment for a QOF.<sup>3</sup>

A QOZB is tested annually,<sup>4</sup> and the first few years can be critical, especially because one bad year early on can be fatal under the QOF Holding Period Test (as defined, and discussed in greater detail, below in Part ii).<sup>5</sup>

Luckily, there is a tool available to help manage the QOZB requirements during a QOZB’s start-up phase: the working capital safe harbor (“WCSH”).<sup>6</sup> This little provision of the Treasury Regulations punches above its weight as a helpful tool to satisfy the QOZB rules, and it can be a downright savior to some QOZBs as they get their businesses up and running.

This article includes: (i) a brief discussion of the QOF 90% Asset Test, (ii) a summary of the QOZB requirements, (iii) a deep dive into the WCSH itself, (iv) an explanation of the 62-Month Safe Harbor

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<sup>1</sup> Code Section 1400Z-2(a)(1); Reg. §1.1400Z2(a)-1(b)(11).

<sup>2</sup> Code Section 1400Z-2(d)(1); Reg. §1.1400Z2(d)-1(b)(2)(i).

<sup>3</sup> Code Section 1400Z-2(d)(3); Reg. §1.1400Z2(d)-1(d).

<sup>4</sup> Reg. §1.1400Z2(d)-1(d)(1).

<sup>5</sup> Code Section 1400Z-2(d)(2)(C)(iii); Reg. §1.1400Z2(d)-1(c)(3)(i)(C).

<sup>6</sup> Reg. §1.1400Z2(d)-1(d)(3)(v).

(defined below) available to a QOZB with a WCSH in place, and (v) an illustration of how the WCSH can play a pivotal role in helping with QOZB compliance.

Although a QOZB can be an operating business unrelated to real estate, this article illustrates the application of the WCSH in the context of a QOZB acquiring, developing and operating real estate. This summary is only a high-level description of the relevant rules, which are nuanced and very fact dependent. Any particular project or development should be fully vetted to ensure it complies with the OZ Program requirements.

## **2. The QOF 90% Asset Test**

For a QOF to be in compliance with the QOF 90% Asset Test, at least 90% of its assets must be qualified opportunity zone property (“QOZP”).<sup>7</sup> The 90% measurement of a QOF’s assets is determined by averaging the QOF’s percentage of QOZP on the last day of the first 6-month period of the taxable year of the QOF, and on the last day of the taxable year of the QOF.<sup>8</sup> For a calendar year QOF, its two testing dates will be June 30<sup>th</sup> and December 31<sup>st</sup>, but its first year may have a different first testing date depending on when it is formed or elects QOF status.

There are specified valuation methodologies for valuing a QOF’s assets for purposes of the QOF 90% Asset Test, as well as for valuing a QOZB’s tangible property for purposes of the Tangible Property Requirement (as defined below). Those valuation methodologies are described below in Part ii.

QOZP can include equity in certain subsidiaries qualifying as QOZBs, as well as qualifying tangible property.<sup>9</sup> For a QOZB that is characterized as a partnership for federal income tax purposes, equity in the QOZB will be a qualifying asset for a QOF only if the QOZB equity held by the QOF is a qualified opportunity zone partnership interest (“QOZPI”).<sup>10</sup>

Similarly, for a QOZB that is characterized as a corporation for federal income tax purposes, the QOZB will be a qualifying asset for a QOF as long as the equity in the QOZB constitutes qualified opportunity zone stock (“QOZS”).<sup>11</sup> The QOZPI and QOZS requirements are similar, but this article assumes that a QOF holds equity in a QOZB characterized as a partnership for federal income tax purposes.

### **i. Qualified Opportunity Zone Partnership Interest**

For a QOZB characterized as a domestic partnership<sup>12</sup> for federal income tax purposes, equity in that QOZB will be a QOZPI if three requirements are met. First, the partnership interest must be acquired by

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<sup>7</sup> Code Section 1400Z-2(d)(1). Reg. §1.1400Z2(a)-1(b)(4).

<sup>8</sup> *Id.*

<sup>9</sup> Code Section 1400Z-2(d)(2)(A).

<sup>10</sup> Code Section 1400Z-2(d)(2)(A)(ii).

<sup>11</sup> Code Section 1400Z-2(d)(2)(A)(i).

<sup>12</sup> Equity in certain entities organized in a U.S. territory can be a QOZPI if the entity conducts a qualified opportunity zone business in the U.S. territory in which the entity is organized. Reg. §1.1400Z2(d)-1(a)(1)(ii)(B)(1).

the QOF after December 31, 2017, from the partnership solely in exchange for cash.<sup>13</sup> This requirement means that a QOF must acquire a newly issued interest from the QOZB. A QOF cannot purchase existing equity in a QOZB from another partner.

Second, as of the time the partnership interest is acquired, the partnership must be a QOZB (or, in the case of a new partnership, the partnership is being organized for the purposes of being a QOZB).<sup>14</sup> The QOZB requirements are explored below in Parts 3, 4 and 5.

Lastly, during substantially all (which is 90% for this purpose) of the QOF's holding period for such partnership interest, the partnership must qualify as a QOZB (the “QOF Holding Period Test”).<sup>15</sup> Because of this holding period requirement, a QOZB's early years can be critical for a QOF owner of a QOZB.

## **ii. QOF Holding Period Test**

The QOF Holding Period Test puts a lot of pressure on QOZB compliance from Day 1 because the Treasury Regulations interpret the relevant statutory language to mean that the QOF Holding Period Test is applied cumulatively.<sup>16</sup> The cumulative nature of the test means that a failure of an entity to meet the QOZB requirements in an early year could be fatal for the QOF. For example, if a partnership failed to be a QOZB during its first two years with a QOF owner, equity in that partnership would not be a QOZPI until the QOF could meet the QOF Holding Period Test on a cumulative basis. Those two bad early years theoretically mean that the QOF Holding Period Test would not be met until after Year 20, since by then the QOZB would finally have 18 years of qualifying as a QOZB to meet the 90% requirement of the QOF Holding Period Test. Of course this is an impractical result, so QOZB compliance is incredibly important, especially early on.

One additional nuance to this analysis is a provision in the Treasury Regulations that states that, for purposes of the QOF Holding Period Test, a QOF determines whether a partnership qualifies as a QOZB on the QOF's semiannual testing dates.<sup>17</sup> The Treasury Regulations also give QOFs the ability to cure a QOZB failure, which is a helpful safety feature. If an entity fails to qualify as a QOZB on a testing date, a QOF owner can still treat its equity in the entity as a QOZPI if the QOZB corrects the failure within 6 months.<sup>18</sup>

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<sup>13</sup> Code Section 1400Z-2(d)(2)(C)(i).

<sup>14</sup> Code Section 1400Z-2(d)(2)(C)(ii).

<sup>15</sup> Code Section 1400Z-2(d)(2)(C)(iii); Reg. §1.1400Z2(d)-1(c)(3)(i)(C).

<sup>16</sup> Reg. §1.1400Z2(d)-1(c)(3)(i)(C)(1).

<sup>17</sup> Reg. §1.1400Z2(d)-1(c)(3)(i)(C)(2).

<sup>18</sup> Reg. §1.1400Z2(d)-1(d)(6).

There is significant confusion as to the application of the semiannual testing rule and the application of the cure provisions, which is outside the scope of this article, and many practitioners think it is appropriate to measure QOZB status for purposes of the QOF Holding Period Test on an annual basis.

Regardless of whether QOZB status is measured annually or semiannually for purposes of the QOF Holding Period Test, because the test is applied cumulatively, a QOZB should be diligent early on to ensure compliance.

### **3. The QOZB Requirements**

An eligible entity engaged in a trade or business is a QOZB if the entity satisfies five requirements (each as defined and further described below): (i) the Tangible Property Requirement, (ii) the Financial Property Limit, (iii) the Gross Income Requirement, (iv) the Intangible Property Requirement, and (v) the Sin Business Prohibition. An eligible entity for this purpose is an entity classified as a corporation or a partnership for federal income tax purposes.<sup>19</sup>

The Tangible Property Requirement is where most real estate QOZBs need to focus. Additionally, the Tangible Property Requirement itself has a series of nested sub-requirements, so it takes a while to cross all the t's and dot all the i's. We will tackle the Tangible Property Requirement first, and then work through the remaining four requirements.

Although the WCSH does not show up in the explanation of the Tangible Property Requirement immediately below in Part 4, we will come full circle by the end so you can see how the WCSH can play a meaningful role in helping a QOZB meet this requirement.

### **4. The Tangible Property Requirement**

Under the tangible property requirement (the “Tangible Property Requirement”), substantially all (which is 70% for this purpose) of the tangible property owned or leased by a QOZB must be qualified opportunity zone business property (“QOZBP”).<sup>20</sup>

Leased tangible property can qualify as QOZBP, but this article focuses on the requirements applicable to tangible property owned by a QOZB.

#### **i. Qualified Opportunity Zone Business Property**

To qualify as QOZBP, tangible property must be used in the trade or business of the QOZB and meet the three requirements described below.

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<sup>19</sup> Reg. §1.1400Z2(d)-1(a)(1)(i).

<sup>20</sup> Code Section 1400Z-2(d)(3)(A)(i); Reg. §1.1400Z2(d)-1(d)(2)(i).

### a. The Development Requirement

First, tangible property owned by the QOZB must meet either the original use test or the substantial improvement test (the “Development Requirement”).<sup>21</sup> Tangible property meets the original use test (the “Original Use Test”) if the original use of the property in an opportunity zone commences with the QOZB, meaning that the QOZB has to be the first person to place the property into service for purposes of depreciation.<sup>22</sup> Any new ground-up construction in an opportunity zone should meet the Original Use Test, and certain “pre-TCO” acquisitions may also qualify (although be mindful that placing a property into service for tax purposes may not coincide with the date the property receives a certificate of occupancy).

Alternatively, tangible property can satisfy the Development Requirement by meeting the substantial improvement test (the “Substantial Improvement Test”). In order to meet the Substantial Improvement Test, within a 30-month period the property must be improved by the QOZB so that the additions to the property’s basis equal or exceed the QOZB’s basis in the property at the beginning of the 30-month period.<sup>23</sup> This is often referred to as the “double your basis” requirement.

For purposes of the Substantial Improvement Test, a QOZB can disregard any basis attributable to land in determining its beginning basis in the property.<sup>24</sup> So if a QOZB acquires an existing building that is already in service and the land underneath the building, the property will be QOZBP if the QOZB makes sufficient improvements to meet the Substantial Improvement Test with respect to the building. There are certain aggregation rules which permit a QOZB to apply the test to groups of buildings collectively, and to include newly placed in service personal property in meeting the Substantial Improvement Test requirements.<sup>25</sup>

Unimproved land does not have to be substantially improved,<sup>26</sup> and land can never meet the Original Use Requirement, but land must be used in the QOZB’s trade or business in order to be considered QOZBP. To address concerns about land-banking, additional requirements kick in if the QOZB purchased the land with an expectation, an intention, or a view not to improve the land more than an insubstantial amount within 30 months of the date of purchase.<sup>27</sup> Be cautious with property acquisitions where there will be large amounts of unimproved land post-development.

The Development Requirement is intended to ensure that a QOZB makes a significant investment in an opportunity zone and either creates or adds value to the property there. A QOZB cannot acquire an

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<sup>21</sup> Code Section 1400Z-2(d)(2)(D)(i)(II); Reg. §1.1400Z2(d)-2(b)(2).

<sup>22</sup> Reg. §1.1400Z2(d)-2(b)(2)(i)(A); Reg. §1.1400Z2(d)-2(b)(3)(i)(A).

<sup>23</sup> Code Section 1400Z-2(d)(2)(D)(ii); Reg. §1.1400Z2(d)-2(b)(4)(i).

<sup>24</sup> Reg. §1.1400Z2(d)-2(b)(4)(iv).

<sup>25</sup> Reg. §1.1400Z2(d)-2(b)(4)(iii); Reg. §1.1400Z2(d)-2(b)(4)(v).

<sup>26</sup> Reg. §1.1400Z2(d)-2(b)(4)(iv)(B).

<sup>27</sup> Reg. §1.1400Z2(d)-2(b)(4)(iv)(C).



existing stabilized asset and have that qualify as QOZBP, since the OZ Program is intended to bring new economic development to the opportunity zones.

### **b. The Purchase Requirement**

Second, tangible property must have been acquired by purchase after December 31, 2017 from a party unrelated to the QOZB (the “Purchase Requirement”).<sup>28</sup> *(Spoiler alert – this is where the WCSH can play a critical role! Read on...)*

There are three components to the Purchase Requirement: the purchase component, the timing component, and the relatedness component.

The purchase component requires that QOZPB be purchased, so contributed property does not qualify. Because of the definition of purchase in the Internal Revenue Code, property only meets this requirement if it is fully acquired in a transaction which gives the QOZB a cost basis in the property.<sup>29</sup> There is an inherent cliff effect as a result of the purchase definition, so if the property is contributed to the QOZB, even in part, the property will fail to meet the Purchase Requirement. Self-constructed property is considered “purchased” for purposes of the Purchase Requirement if the QOZB manufactures, constructs, or produces the tangible property for use by the QOZB and with the intent to use the property in the QOZB’s trade or business in an opportunity zone.<sup>30</sup>

As a result of the timing component, even if property was acquired by purchase, the property will not be QOZBP if the property was acquired before January 1, 2018.

Lastly, the relatedness component requires that the property be acquired by the QOZB from an unrelated party. Parties are related for this purpose if there is common ownership of more than 20%.<sup>31</sup> If the property is acquired by the QOZB from a seller owning more than 20% (directly or indirectly) of the QOZB, the property will not be QOZBP.<sup>32</sup>

If a QOZB purchases undeveloped land in 2018 for cash from an unrelated party and constructs a new building on that land, the land should meet the Purchase Requirement because it was acquired by purchase from an unrelated party after December 31, 2017, and the new building should meet the Purchase Requirement because of the self-constructed property rules.

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<sup>28</sup> Code Section 1400Z-2(d)(2)(D)(i)(I); Reg. §1.1400Z2(d)-2(b)(1)(i).

<sup>29</sup> Code Section 179(d)(2).

<sup>30</sup> Reg. §1.1400Z2(d)-2(b)(1)(iii).

<sup>31</sup> Code Section 1400Z-2(d)(2)(D)(iii); Code Section 707(b)(1), as modified by Code Section 1400Z-2(e)(2).

<sup>32</sup> Although not the focus of this article, be mindful of any property acquisition from a seller that reinvests into the QOZB, directly or indirectly (through a QOF or otherwise), even if the seller stays under 20%. Certain “circular cash flow” transactions may be subject to attack by the IRS under the step transaction doctrine. T.D. 9889, 85 Fed. Reg. 1866, 1871 (Jan. 13, 2020); Reg. §1.1400Z2(f)-1(c)(3)(iii).

### c. The Use in an Opportunity Zone Test

Third, during substantially all (90% for this purpose) of the QOZB's holding period of QOZBP, substantially all (70% for this purpose) of the use of the tangible property must be in an opportunity zone.<sup>33</sup> This test is more critical in the context of an operating business where tangible property may move in and out of an opportunity zone (machinery, laptops, etc.). Luckily, most tangible property in a real estate QOZB tends to stay put.

### ii. Valuation for Purposes of the Tangible Property Requirement

The Treasury Regulations include specified valuation methodologies for valuing a QOF's assets for purposes of the QOF 90% Asset Test, as well as for valuing a QOZB's tangible property for purposes of the Tangible Property Requirement. This discussion reviews those valuation methods in the context of a QOZB valuing its tangible property, but the same concepts apply for a QOF valuing its assets for the QOF 90% Asset Test.

A QOZB has two methods to choose from to value its tangible property for purposes of the Tangible Property Requirement: the applicable financial statement method (the "AFS Method") or the alternative valuation method (the "AV Method").<sup>34</sup> A QOZB can switch methods from year to year, but it must apply a single method consistently during each taxable year to all of its tangible property.<sup>35</sup>

#### a. The AFS Method

A QOZB may only use the AFS Method in a taxable year if the QOZB has an applicable financial statement within the meaning of the Treasury Regulations.<sup>36</sup>

An applicable financial statement of an entity is either (i) a financial statement that is prepared in accordance with U.S. GAAP and required to be filed with the SEC, such as a Form 10-K,<sup>37</sup> or (ii) a financial statement that (A) meets certain significant use requirements, including that the financial statement values are used by the entity in most of the significant management functions of its business and that the use of the financial statement values are related to the management of all or substantially all of the business,<sup>38</sup> and (B) is prepared in accordance with U.S. GAAP, and is either (x) required to be provided to the federal government or any of its agencies other than the IRS,<sup>39</sup> or (y) a certified audited

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<sup>33</sup> Code Section 1400Z-2(d)(2)(D)(i)(III); Reg. §1.1400Z2(d)-2(d)(1).

<sup>34</sup> Reg. §1.1400Z2(d)-1(b)(1)(ii); Reg. §1.1400Z2(d)-1(b)(2)(ii)(A). Although not the focus of this article, the Treasury Regulations also contain a helpful provision which allows a QOF investor that owns 5% of more of the equity in a QOZB to value the QOZB's tangible property using the same valuation methodology that the QOF uses to measure its own assets under the QOF's 90% asset test. Reg. §1.1400Z2(d)-1(b)(2)(ii)(B).

<sup>35</sup> Reg. §1.1400Z2(d)-1(b)(2)(ii)(A).

<sup>36</sup> Id.

<sup>37</sup> Reg. §1.475(a)-4(h)(1); Reg. §1.475(a)-4(h)(2)(i).

<sup>38</sup> Reg. §1.475(a)-4(j).

<sup>39</sup> Reg. §1.475(a)-4(h)(2)(ii).



financial statement that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the entity, or provided for other substantial non-tax purposes, and in either case for purposes of this clause (y), the entity must reasonably anticipate that the financial statement will be directly relied on for the purposes for which it was given or provided.<sup>40</sup>

If the QOZB chooses the AFS Method, it can use the values of its assets as reported on its applicable financial statement for the relevant reporting period.<sup>41</sup>

### **b. The AV Method**

Under the AV Method, for any tangible property that the QOZB acquired by purchase for fair market value or constructed for fair market value, the value of the property is the QOZB's unadjusted cost basis of the property.<sup>42</sup> However, the value of property that is not purchased or constructed for fair market value is the asset's fair market value, as determined on the last day of the first six-month period of the taxable year and on the last day of the taxable year.<sup>43</sup>

This dichotomy in valuation approaches under the AV Method is problematic and adds unnecessary compliance costs. For example, if a QOZB owns both contributed property and property constructed for fair market value, under the AV Method the value of the self-constructed property will remain at its unadjusted cost basis, but the value of the contributed property may fluctuate. Aside from the unrealistic expectation that a QOZB is going to obtain valuation reports on its contributed property every six months, the reliance on a fair market value determination for purposes of the Tangible Property Requirement may make compliance very difficult to predict.

## **5. The Four Remaining QOZB Requirements**

The four remaining QOZB requirements are the Financial Property Limit, the Gross Income Requirement, the Intangible Property Requirement, and the Sin Business Prohibition.

### **i. The Financial Property Limit**

The OZ Program was created to encourage investment in opportunity zones to drive economic activity. Although both real estate development and non-real estate operating businesses are permitted, the OZ Program framework does not permit investors to claim the OZ Program tax benefits for investments in financial products. This restriction takes the form of a limit on a QOZB's financial assets (the "Financial Property Limit"). Under the Financial Property Limit, less than 5 percent of the average aggregate unadjusted bases of the QOZB's property can be attributable to nonqualified financial property.<sup>44</sup>

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<sup>40</sup> Reg. §1.475(a)-4(h)(2)(iii).

<sup>41</sup> Reg. §1.1400Z2(d)-1(b)(3)(i).

<sup>42</sup> Reg. §1.1400Z2(d)-1(b)(4)(ii)(A).

<sup>43</sup> Reg. §1.1400Z2(d)-1(b)(4)(ii)(B).

<sup>44</sup> Code Section 1400Z-2(d)(3)(A)(ii) by reference to Code Section 1397C(b)(8); Reg. §1.1400Z2(d)-1(d)(3)(iv).

To determine whether the Financial Property Limit is exceeded in any taxable year, a fraction is calculated, the numerator of which is the average aggregate unadjusted basis of the QOZB's nonqualified financial property, and the denominator of which is the average aggregate unadjusted basis of all of the QOZB's property (including the nonqualified financial property). Although the average for the numerator and the denominator should be determined in the same manner, there is no explicit guidance on how to calculate the average. A few reasonable approaches include calculating the average on a daily, monthly or quarterly basis, or alternatively averaging the QOZB's property on the QOF's semiannual testing dates.

#### **a. Nonqualified Financial Property**

Nonqualified financial property includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property.<sup>45</sup>

However, nonqualified financial property does not include (1) reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less ("Working Capital Assets"), and (2) business receivables described in Code Section 1221(a)(4).<sup>46</sup>

#### **b. Reasonable Amounts of Working Capital**

There is no definition for what constitutes a reasonable amount of working capital for purposes of the exception for Working Capital Assets. In other contexts for determining necessary amounts of working capital, courts have relied upon several approaches, including permitting one year's worth, or one "operating cycle's worth", of operating expenses.<sup>47</sup> However, those approaches were intended for businesses that produce inventory and may not be appropriate to measure a reasonable amount of working capital for a real estate business.

In order to provide some certainty to QOZBs, the Treasury Regulations provide a safe harbor that permits a QOZB to treat its Working Capital Assets as a reasonable amount. This is our little hero, the WCSH. The WCSH is discussed in greater detail below in Part 6.

Keep in mind that the WCSH is just a safe harbor, so a QOZB can use other methods to show that its Working Capital Assets are reasonable in amount. For example, once a QOZB has its real estate development completed and is operating its property, a QOZB should be able to keep an amount of cash on hand for reasonably expected capital expenditures. However, during a QOZB's early years, use of the WCSH is encouraged, especially because it allows a QOZB to rely on the 62-Month Safe Harbor as well (which is discussed below in Part 7).

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<sup>45</sup> Code Section 1397C(e).

<sup>46</sup> Code Section 1397C(e)(1) and (2).

<sup>47</sup> *Bardahl Mfg. Corp. v. Comm'r.*, 70 T.C. Memo 1965-200.

## **ii. The Gross Income Requirement**

Under the Gross Income Requirement, in each taxable year a QOZB has to generate at least 50% of its gross income from the active conduct of its trade or business in an opportunity zone.<sup>48</sup> Again, this requirement tends to get more attention in an operating business QOZB. For real estate QOZBs that generate their income from their developed or improved real estate, this should not be an issue.

## **iii. The Intangible Property Requirement**

At least 40% of a QOZB's intangible property must be used in the active conduct of the QOZB's trade or business in an opportunity zone.<sup>49</sup> This is another requirement that tends to be less critical for real estate QOZBs.

## **iv. The Sin Business Prohibition**

A QOZB cannot be a specified "sin business", such as a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.<sup>50</sup> Additionally, a QOZB cannot lease more than a *de minimis* amount of property (less than 5% of the net rentable square feet of its real property) to any of the sin businesses.<sup>51</sup>

# **6. The Working Capital Safe Harbor**

As noted above, the WCSH is a tool that QOZBs can use to manage compliance with the Financial Property Limit. If a QOZB properly documents and maintains a WCSH, its Working Capital Assets are treated as reasonable in amount and any financial property (such as cash) that is covered by the WCSH loses its disqualifying taint.<sup>52</sup> Keep in mind that Working Capital Assets include equity contributions, from a QOF or a non-QOF partner, as well as borrowed amounts from a loan.

## **i. Three WCSH Requirements**

In order for a QOZB's Working Capital Assets to be considered reasonable in amount under the WCSH, there are three requirements.

First, the QOZB must prepare a statement in writing that the QOZB's Working Capital Assets are designated for the development of a trade or business in an opportunity zone, including if appropriate

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<sup>48</sup> Code Section 1400Z-2(d)(3)(A)(ii) by reference to Code Section 1397C(b)(2); Reg. §1.1400Z2(d)-1(d)(3)(i).

<sup>49</sup> Code Section 1400Z-2(d)(3)(A)(ii) by reference to Code Section 1397C(b)(4); Reg. §1.1400Z2(d)-1(d)(3)(ii).

<sup>50</sup> Code Section 1400Z-2(d)(3)(A)(iii) by reference to Code Section 144(c)(6)(B); Reg. §1.1400Z2(d)-1(d)(4).

<sup>51</sup> Reg. §1.1400Z2(d)-1(d)(4)(i).

<sup>52</sup> Reg. §1.1400Z2(d)-1(d)(3)(v).

the acquisition, construction, or substantial improvement of tangible property in an opportunity zone (the “Statement”).<sup>53</sup>

Second, the QOZB must prepare a written schedule for the planned expenditure of the Working Capital Assets within 31 months of the receipt by the QOZB of the Working Capital Assets (the “31-Month Schedule”).<sup>54</sup>

Third, the QOZB must actually use the Working Capital Assets in a manner that is substantially consistent with the Statement and the 31-Month Schedule (the “Consistent Use Requirement”).<sup>55</sup>

## **ii. The Statement and the 31-Month Schedule**

The Treasury Regulations do not provide much additional guidance on how specific the Statement or 31-Month Schedule needs to be. There are no official templates or other examples of what a WCSH compliance plan should actually look like.

### **a. The Statement**

On the Statement, there is a fine line to walk between being detailed enough, but not too detailed. Under the Consistent Use Requirement, Working Capital Assets must be used in a manner that is substantially consistent with the Statement and 31-Month Schedule, and any disagreement about what “substantially consistent” actually means will come down to the facts. For example, if the development plan is to build a multifamily property at a specific site with 75 units, a parking garage, and 3 retail units, then the Statement might say that the plan is to build a multifamily property at a specific site, possibly with a parking garage and retail, pending final approvals and architectural plans. This way if the project ends up having 80 units and a parking garage, but no retail, it is within the scope of the Statement.

If the site plans themselves are still up in the air depending on environmental considerations, zoning approvals, or some other uncertainty, then the Statement should reflect as many details as possible about the project, and perhaps a few alternatives depending on how the uncertainties might play out. The Statement should also note the reason for the lack of specificity, so any future reader (such as an IRS audit agent) understands why the Statement is not more definitive. Once the QOZB’s plans become clearer, it might consider updating the Statement, but be mindful of making wholesale changes as explained below.

If a QOZB was formed to help manage certain investment deadlines and is essentially a place to “park” at least 90% of a QOF’s assets so that the QOF does not fail its 90% investment test, then the Statement should indicate as many details as possible about the intended business of the QOZB. For example, if the QOZB is intending to acquire property in a certain geographic region or in a certain asset class,

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<sup>53</sup> Reg. § 1.1400Z2(d)-1(d)(3)(v)(A).

<sup>54</sup> Reg. § 1.1400Z2(d)-1(d)(3)(v)(B).

<sup>55</sup> Reg. § 1.1400Z2(d)-1(d)(3)(v)(C).

certainly include that information. The WCSH file should also contain written records showing efforts made to secure an investment, such as emails to potential sellers inquiring about a property, letters of intent, draft term sheets, financing materials from possible lenders, and marketing materials from the QOF itself (if relevant). There is no guarantee that a Statement without a specific property will pass muster, so the more evidence a QOZB has to show diligent efforts to obtain qualifying property, the better.

### **b. The 31-Month Schedule**

Similarly, the 31-Month Schedule should have a hefty amount of detail. The balancing act for the QOZB will be to include enough evidence to show a true plan to spend the Working Capital Assets in the 31-month period without getting bogged down in specifying costs to the penny.

Given the Consistent Use Requirement, it may actually be better to bundle certain expenses, and to list expected costs as ranges, instead of specific amounts. For example, instead of specifying hard dollar costs for each building material, it should be sufficient to list “building materials (including, steel, cement, wood, etc.)” and then a range of the expected costs. Prices can fluctuate over time, as well as design plans, and a QOZB does not want to risk failing the Consistent Use Requirement because the granite countertops cost more than its initial budgeted cost.

### **c. Changes to the Statement and 31-Month Schedule**

Changes to a QOZB’s development plans might occur for completely legitimate business reasons, such as either the approval or failure of certain applications (zoning, etc.), because of the discovery of new circumstances (an environmental issue), or even a global public health crisis. With the COVID-19 pandemic, there may be projects which no longer make sense. For example, developing a new hotel in a dense urban area may not be the best use of a QOZB’s investment dollars.

The good news is that Treasury recently released new proposed regulations which grant some flexibility to a QOZB to revise or replace its Statement and 31-Month Schedule in certain situations.<sup>56</sup> The bad news is that changes to a QOZB’s Statement and 31-Month Schedule are only explicitly blessed if those changes are made in response to a federally declared disaster. Under these new regulations, a new or revised Statement and 31-Month Schedule can be used only if they are adopted within 120 days after the close of a federally declared disaster.<sup>57</sup> Even if a QOZB changes its Statement and 31-Month Schedule in accordance with these rules, it is still subject to the original 31-month period to use its Working Capital Assets, plus the up-to-24 additional months pursuant to the federal disaster relief provisions (discussed below).<sup>58</sup>

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<sup>56</sup> REG-121095-19 (Apr. 12, 2021).

<sup>57</sup> Prop. Reg. § 1.1400Z2(d)-1(d)(3)(v)(D).

<sup>58</sup> *Id.*

As provided below in Part (6)(iii)(b), the COVID-19 pandemic is a federally declared disaster, which remains open as of the writing of this article. So any QOZBs that need to pivot as a result of the pandemic can do so with confidence that they are operating within official guidance.<sup>59</sup>

Unfortunately, other than in response to a federally declared disaster, it appears that a QOZB cannot change its Statement and 31-Month Schedule without jeopardizing its compliance with the WCSH rules. Unless and until this flexibility is broadened beyond changes made in response to a federally declared disaster, be very cautious about otherwise making wholesale changes to a QOZB's Statement and 31-Month Schedule. Although it seems reasonable to permit changes made based on commercial justifications, if those changes are made outside the scope of the new guidance or otherwise could result in a QOZB not using its Working Capital Assets in a manner that is substantially consistent with the originally drafted Statement and the 31-Month Schedule, a QOZB risks failing the Consistent Use Requirement.

### **iii. Consistent Use Requirement and Delays**

As noted above, under the Consistent Use Requirement the QOZB has to use its Working Capital Assets in a manner that is *substantially consistent* with the Statement and the 31-Month Schedule. This language already permits a small amount of deviation from the original plans, but if a QOZB's development plans change midway, it should consider updating the Statement and the 31-Month Schedule.

Despite a QOZB's best laid plans, most likely (or perhaps most certainly) there will be delays in its project. A small delay is unlikely to cause a QOZB to fail the Consistent Use Requirement, especially if it has built in enough wiggle room to account for typical minor delays. However, a larger delay could cause an issue with the Consistent Use Requirement, especially if the delay pushes the QOZB's timeline past the permitted 31 months. Luckily, the WCSH rules provide some flexibility for delays.

#### **a. Governmental Approvals**

First, the Treasury Regulations permit some leeway on account of delays attributable to waiting for certain types of approvals. If a QOZB is not able to spend its Working Capital Assets in accordance with the 31-Month Schedule because it is waiting for government action on a completed application, that delay does not cause the QOZB to fail the Consistent Use Requirement.<sup>60</sup> For example, if (1) a QOZB is waiting on a building permit, zoning change, tax lot designation or merger, or environmental certificate, and (2) that waiting period causes an actual delay in the QOZB's ability to spend its Working Capital Assets as set out in its 31-Month Schedule, then the QOZB does not fail the Consistent Use Requirement.

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<sup>59</sup> Although these new proposed regulations are not effective until finalized, taxpayers can rely on them beginning in taxable year 2020.

<sup>60</sup> Reg. § 1.1400Z2(d)-1(d)(3)(v)(C).



Although the Treasury Regulations themselves do not elaborate on the term “delay”, the preamble to those regulations adds some helpful color. Treasury and the IRS’s view is that a tolling of the 31-month period would not be appropriate if the governmental delay does not pose a substantial obstacle to a QOZB’s project.<sup>61</sup> However, if a governmental permitting delay has caused the delay of a project covered by a WCSH, and no other action could be taken to improve the property or complete the project during the permitting process, then the 31-month period should be tolled for a duration equal to the permitting delay.<sup>62</sup> Given the factual nature of such a delay, and the subjective nature of what a “substantial obstacle” might be, a QOZB should keep detailed records on when various applications are submitted and when any delay of the project begins and ends in case it needs to take advantage of this tolling rule.

#### **b. Federally declared disasters**

Second, if a QOZB is located in an opportunity zone that is within a federally declared disaster area, the QOZB is granted not more than an additional 24 months to use its Working Capital Assets without failing the Consistent Use Requirement.<sup>63</sup> Although the Treasury Regulations do not explicitly tie the availability of the extra 24 months to a project delay, the preamble to the Treasury Regulations indicates that a QOZB can only take advantage of the extra time to the extent of any delay attributable to the federally declared disaster.<sup>64</sup> Again, a QOZB should keep detailed records about its project and the project’s progress (or lack thereof).

The IRS has clarified that the Emergency Declaration made in March 2020 as a result of COVID-19 resulted in all 50 states, the District of Columbia, and five territories being federally declared disaster areas.<sup>65</sup> Since every opportunity zone is now in a federally declared disaster area, any QOZB with Working Capital Assets covered by a WCSH before June 30, 2021 can take advantage of the extra 24 months for purposes of the Consistent Use Requirement.<sup>66</sup> However, regardless of the certainty of every opportunity zone being in a federally declared disaster area, the same uncertainties noted above regarding project delays continue to apply. QOZBs may be required to prove delays attributable to the pandemic in order to toll their 31-month period, so good records will be helpful, if not critical.

#### **iv. Multiple WCSHs**

Depending on a QOZB’s project, capital may be needed in stages as the project progresses. For example, a QOZB may need cash initially to acquire the property and conduct certain pre-development activities. Once the QOZB is ready to progress the development, it would need additional funds for construction.

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<sup>61</sup> T.D. 9889, 85 Fed. Reg. 1866, 1926 (Jan. 13, 2020).

<sup>62</sup> *Id.*

<sup>63</sup> Reg. §1.1400Z2(d)-1(d)(3)(v)(D).

<sup>64</sup> T.D. 9889, 85 Fed. Reg. 1866, 1926 (Jan. 13, 2020).

<sup>65</sup> Notice 2020-39, 2020-26 IRB 984, 06/05/2020; Notice 2021-10, 2021-6 IRB, 01/20/2021.

<sup>66</sup> Notice 2021-10, 2021-6 IRB, 01/20/2021.

If the total timeline for the project exceeds 31 months, the QOZB should not collect all of the required capital upfront, since it will not be able to comply with the WCSH rules which require spending the Working Capital Assets within 31 months.

Thankfully, a QOZB can have multiple sequential or overlapping WCSHs, as long as each one meets the three requirements set out above in Part i.<sup>67</sup> This means that each WCSH has to have its own Statement and 31-Month Schedule, and the QOZB must meet the Consistent Use Requirement for each WCSH.

For example, the QOZB could initially be funded with sufficient cash to acquire the property and to pay for expected pre-development costs. The Statement for this “Pre-Development WCSH” could indicate that the QOZB will acquire property at a specific site, begin the permitting and approvals process, and undertake environmental remediation of the property, with an ultimate view of developing and operating newly constructed property. The 31-Month Schedule for the Pre-Development WCSH would include the expected costs and timeline (within 31 months) for the property acquisition and the corresponding pre-development activities. The Working Capital Assets noted in the Pre-Development WCSH need to be spent as indicated in the 31-Month Schedule.

When the QOZB receives additional capital for the construction phase of the project, it would start a new “Construction WCSH”. The Statement for the Construction WCSH would indicate that the QOZB is going to use its Working Capital Assets to construct the new property, subject to all the detailing rules noted above, and the 31-Month Schedule for the Construction WCSH would list the expected use of the Working Capital Assets over a 31-month period. The Working Capital Assets noted in the Construction WCSH need to be spent as indicated in the 31-Month Schedule.

If the two WCSHs are sequential so that the Construction WCSH begins when new capital is contributed in month 32, this does not mean that the QOZB has 62 months to spend its initial capital from the Pre-Development WCSH. The Working Capital Assets covered by the Pre-Development WCSH must be spent within the first 31 months, subject to any tolling rules, and the Working Capital Assets contributed in month 32 that are covered by the Construction WCSH need to be spent during months 32 through 62, again subject to any tolling. So be thoughtful about when cash is contributed to a QOZB (or borrowed by a QOZB), since the 31-month clock starts running when the QOZB receives the Working Capital Assets.

If the two WCSHs are overlapping, the QOZB should take care to document the use of the Working Capital Assets as between the two WCSHs. Cash is fungible of course, but good recordkeeping will help to show that the QOZB was always in compliance with the WCSH rules. The initial Pre-Development

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<sup>67</sup> Reg. §1.1400Z2(d)-1(d)(3)(v)(E).

WCSH can continue until month 31, plus any tolling, even if the QOZB has already started the Construction WCSH.

The Treasury Regulations also indicate that each WCSH has to include a substantial amount of Working Capital Assets. If the QOZB has a WCSH in place and receives a small amount of capital 10 months into its 31-month period, and if the new capital will be used for the purposes set out in the Statement, the QOZB should amend its 31-Month Schedule to indicate (1) the additional Working Capital Assets and (2) how those funds will be used in the remaining 21 months left in the WCSH period. If the QOZB has a WCSH in place and receives a substantial amount of Working Capital Assets for a new phase of the project, the QOZB should begin a new WCSH for those assets with a new Statement and 31-Month Schedule.

#### **v. Paperwork**

The WCSH is not sent to the IRS or attached to either the QOF or QOZB's tax returns. Except in the case of an audit, the IRS is not likely to ever see a QOZB's WCSH. Still, this is a crucial recordkeeping exercise for the QOZB and a critical piece of QOZB compliance.

Remember that a QOF has a 90% asset test to meet annually. In a single asset deal, the QOF's only significant asset is likely to be equity in a single QOZB. Therefore, if the QOZB fails to be a good QOZB, the QOF fails the QOF 90% Asset Test. Without a proper WCSH in place, a QOZB might fail the Financial Property Limit if it has too much cash on hand. If the QOZB does not meet the Financial Property Limit, it is not a good QOZB which could result in the QOF failing the QOF 90% Asset Test.

When a QOF files its tax return every year, it needs to certify compliance with the QOF 90% Asset Test, so every QOF that owns equity in a QOZB will likely be seeking some sort of certification that the QOZB meets all of the QOZB requirements. While it remains to be seen exactly how standardized QOZB compliance reports will become, expect that QOFs will request copies of a QOZB's WCSH to ensure that the QOZB is in compliance with the Financial Property Limit.

### **7. 62-Month Safe Harbor**

The WCSH is a tool available to QOZBs to help manage compliance with the Financial Property Limit. Moreover, use of the WCSH enables a QOZB to rely on a 62-month "start-up" safe harbor for QOZBs (the "62-Month Safe Harbor"),<sup>68</sup> understanding that it may take a QOZB some time to actually start its trade or business. For example, a QOZB may need several years to complete its real estate development before it can begin operating the property as a trade or business. As described in more detail below, the 62-Month Safe Harbor helps a QOZB comply with three of the QOZB requirements (the Tangible

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<sup>68</sup> Reg. § 1.1400Z2(d)-1(d)(3)(vi)(A).

Property Requirement, the Gross Income Requirement, and the Intangible Property Requirement) during its first 62 months.

#### **i. WCSH Required**

In order to take advantage of the 62-Month Safe Harbor, a QOZB has to have one or more WCSHs in place during the 62-month period.<sup>69</sup> Each of those WCSHs has to independently meet all of the WCSH requirements, so the Working Capital Assets from an expiring 31-month WCSH must be spent in accordance with the Consistent Use Requirement.<sup>70</sup>

Any subsequent infusions of capital into the QOZB should be used in furtherance of the QOZB's Statement and 31-Month Schedule as drafted in its WCSH, and any overlapping or sequential applications of the WCSH have to include a substantial amount of Working Capital Assets.<sup>71</sup> This requirement that subsequent WCSHs include a "substantial amount" of Working Capital Assets is intended to prevent abusive situations where a QOZB might try to artificially extend its time to complete its development by creating new WCSHs for small amounts. Unfortunately there is no guidance on what "substantial amount" means, but any subsequent WCSH should be for more than a de minimis amount of capital. Additionally, a subsequent WCSH should cover a new phase or aspect of the development that is not part of a prior WCSH.

Remember that borrowed funds also constitute Working Capital Assets.<sup>72</sup> This means that a QOZB can use contributed equity from a QOF, for example, to acquire property and pay for pre-development expenses, all in accordance with an initial WCSH. The QOZB can then use proceeds from a construction loan for the actual development in accordance with a second WCSH, which can either be overlapping with the first WCSH or sequential.

Note that the 62-Month Safe Harbor does not extend the 31-month WCSH to 62 months. A QOZB does not have 62 months from the time it receives Working Capital Assets to use those amounts under a single WCSH. A QOZB still has only 31 months from the date it receives Working Capital Assets to consume those assets, subject to possible tolling for delays. Rather, the 62-Month Safe Harbor allows a QOZB to string together WCSHs with multiple infusions of cash over time in order to develop its business.

At the expiration of a QOZB's 62-Month Safe Harbor (which can be less than 62 months if the QOZB does not have WCSHs in place for the full 62 months), a QOZB will have to meet all of the QOZB requirements independently without the benefit of the 62-Month Safe Harbor.

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<sup>69</sup> Reg. §1.1400Z2(d)-1(d)(3)(vi)(A)(1).

<sup>70</sup> Reg. §1.1400Z2(d)-1(d)(3)(vi)(A)(2).

<sup>71</sup> Reg. §1.1400Z2(d)-1(d)(3)(vi)(A)(3); §1.1400Z2(d)-1(d)(3)(vi)(A)(4).

<sup>72</sup> Reg. §1.1400Z2(d)-1(d)(3)(vi)(A)(4).

## **ii. 62-Month Gross Income Safe Harbor**

Under the 62-Month Safe Harbor, if a QOZB derives any gross income from Working Capital Assets that are covered by a WCSH, that gross income is counted towards satisfaction of the Gross Income Requirement during the WCSH period.<sup>73</sup> This is helpful because a QOZB in the midst of a real estate development is not likely to have any gross income yet from its trade or business. Absent this safe harbor, if the QOZB has some of its Working Capital Assets in an interest bearing account, that interest income could jeopardize the QOZB's ability to comply with the Gross Income Requirement, since even a *de minimis* amount of interest income could exceed 50% of the QOZB's gross income in an early year.

## **iii. 62-Month Intangible Property Safe Harbor**

The 62-Month Safe Harbor also provides some relief to a QOZB in meeting the Intangible Property Requirement. Any intangible property purchased or licensed by the QOZB pursuant to a valid WCSH satisfies the Intangible Property Requirement during the WCSH period.<sup>74</sup> This is helpful because the QOZB would otherwise be required to use at least 40% of its intangible property in its trade or business in an opportunity zone. If the QOZB has not yet started its business, it would not be able to meet the Intangible Property Requirement.

## **iv. 62-Month Tangible Property Requirement**

The 62-Month Safe Harbor provisions that apply with respect to the Tangible Property Requirement are more of a complicated story.

### **a. December 2019 Final Regulations**

When the final Treasury Regulations were released in December 2019, there was a provision which offered some relief on the Tangible Property Requirement to a QOZB during the WCSH. Under that provision, if a QOZB has a valid WCSH in effect with a Statement that designates Working Capital Assets for the acquisition, construction or substantial improvement of tangible property in an opportunity zone, and, as a result of the expenditure the Working Capital Assets in accordance with the WCSH, the tangible property referenced in the Statement is expected to ultimately meet the requirements applicable to QOZBP, then the tangible property is treated as QOZBP during the WCSH period and subsequent WCSH periods that the property is subject to (the "QOZBP Relief").<sup>75</sup>

The QOZBP Relief was viewed as a helpful provision for QOZBs, since it could take many years before a QOZB's tangible property can meet the QOZBP requirements, particularly the Development Requirement.

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<sup>73</sup> Reg. §1.1400Z2(d)-1(d)(3)(vi)(B).

<sup>74</sup> Reg. §1.1400Z2(d)-1(d)(3)(vi)(C).

<sup>75</sup> This provision was moved with the April 2020 Corrections to Reg. §1.1400Z2(d)-1(d)(3)(vi)(D)(2).

### b. April 2020 Correcting Amendments

Treasury revised the 62-Month Safe Harbor when it issued Correcting Amendments in April 2020 to the final Treasury Regulations, but those corrections themselves are still very much in need of cleanup. The Correcting Amendments included a new expanded section to the Treasury Regulations addressing the interaction between the Tangible Property Requirement and the WCSH, with three main takeaways.

First, Treasury clarified that Working Capital Assets are not QOZBP.<sup>76</sup> Prior to the Correcting Amendments, some practitioners took the position that Working Capital Assets covered by a WCSH could be treated as a proxy for the QOZBP that would ultimately be constructed or developed with those assets. There was language in the preamble to the final Treasury Regulations which indicated that this interpretation may have been correct. However, the new provisions in the Correcting Amendments stated that Working Capital Assets cannot be treated as QOZBP for any purpose.<sup>77</sup>

Second, and more puzzling, new language was added to the Treasury Regulations regarding the effect on a QOZB of compliance with the WCSH provisions. The new language (the “New QOZB Provision”) states that if a QOZB has a valid WCSH in effect, then the QOZB satisfies the QOZBP requirements during the WCSH period(s).<sup>78</sup> The QOZB is an entity and QOZBP is tangible property, so there was considerable confusion about what Treasury was trying to accomplish with this provision, since it is not clear how an entity can satisfy the requirements applicable to tangible property.

Since the release of the Correcting Amendments, one emerging interpretation of the New QOZB Provision is that, during a WCSH period, a QOZB is deemed to meet the Tangible Property Requirement, because the Tangible Property Requirement incorporates the QOZBP requirements. Under this interpretation (the “70% Suspension Interpretation”), during a WCSH period the QOZB meets the Tangible Property Requirement regardless of whether 70% of the QOZB’s tangible property is QOZBP, which means that the Tangible Property Requirement is effectively suspended during a valid WCSH period.

One reason why some practitioners doubt the 70% Suspension Interpretation is that Treasury could have drafted the New QOZB Provision to say that if a QOZB has a valid WCSH in effect, then the QOZB satisfies the *Tangible Property Requirement* (instead of the QOZBP requirements) during the WCSH period(s). It would have been very simple for Treasury to include the correct cross reference to the Tangible Property Requirement if that is what they meant.

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<sup>76</sup> Reg. § 1.1400Z2(d)-1(d)(3)(vi)(D)(1).

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*



Apparently, despite the unclear drafting, both IRS Office of Chief Counsel and Treasury have confirmed that this was their intent in informal conversations. Some law firms and some accounting firms (including at least one of the “Big 4”) believe the 70% Suspension Interpretation is correct.

Third, the Correcting Amendments included, with minor revisions, the same QOZBP Relief that had originally been included in the December 2019 Final Regulations. Remember that under the QOZBP Relief, a QOZB’s tangible property can be treated as QOZBP during the WCSH period(s). But if the 70% Suspension Interpretation is correct, so that the Tangible Property Requirement is suspended during the WCSH period, then why did Treasury bother to include the QOZBP Relief which treats tangible property as QOZBP during the WCSH period? If the Tangible Property Requirement is suspended during the WCSH period, then the QOZBP Relief becomes superfluous. This is another reason why practitioners are still split on whether the 70% Suspension Interpretation of the New QOZB Provision is correct.

The one thing that practitioners do agree on is that clarification is badly needed with respect to the New QOZB Provision. Treasury might have offered significant sweeping relief and a very broad runway for QOZBs during their start-up phase, but the unclear nature of the guidance means that even practitioners who believe that the 70% Suspension Interpretation is correct are advising their clients that such an interpretation is not free from doubt.

## **8. The Power of the WCSH**

Putting aside the confusion regarding the 70% Suspension Interpretation for a moment, the WCSH is a powerful tool. Not only does it help a QOZB navigate the Financial Property Limit, but it also opens the door to the 62-Month Safe Harbor and relief on the Gross Income Requirement and the Intangible Property Requirement.

With respect to the Tangible Property Requirement and relief under the 62-Month Safe Harbor, there are two possibilities. First, the QOZBP Relief means that work in process can qualify as QOZBP during the WCSH period, which is helpful in its own right. Second, if the 70% Suspension Interpretation of the New QOZB Provision is correct and the Tangible Property Requirement is suspended during the WCSH period, impossible projects all of a sudden become possible.

For example, assume one party owns land in an opportunity zone, but does not want to sell it. If that party were to contribute raw land into a QOZB, the land would not be QOZBP because it would fail the Purchase Requirement. However, assume the land owner contributes the land into the QOZB and a QOF contributes cash into the QOZB for development. If the 70% Suspension Interpretation is the correct interpretation of the New QOZB Provision, then the Tangible Property Requirement is suspended during the WCSH period. If the QOZB builds new improvements constituting QOZBP that exceed 70% of the value of all of the tangible property in the QOZB by the end of the WCSH period, then that project becomes viable as an opportunity zone development even though the initial land would not meet the Purchase Requirement. This would be an amazing accomplishment, only made possible by the little WCSH.

Alternatively, if the 70% Suspension Interpretation is not the correct interpretation of the New QOZB Provision, then the QOZB in this example would fail the Tangible Property Requirement in its early years because its only tangible property would be the contributed land, which can never be QOZBP. Because of the QOF Holding Period Test, equity in the QOZB would fail to be a QOZPI. If the QOZB was the QOF's sole investment, the QOF would fail to meet the QOF 90% Asset Test. That project would therefore not be able to attract QOF investors. The 70% Suspension Interpretation can be a make-or-break issue for some opportunity zone projects, and it is a shame that this issue is still so murky.

There is certainly an argument that the 70% Suspension Interpretation is consistent with the intent behind the OZ Program. If the Tangible Property Requirement itself only requires that 70% of a QOZB's tangible property be QOZBP, then it also makes sense to give QOZBs some time to get into compliance with that requirement. In the case of a new to-be-constructed real estate project that will eventually meet the Tangible Property Requirement because at least 70% of the value of the project is newly constructed improvements, it should not be disqualifying to build those improvements on non-QOZBP land. Hopefully the Land of OZ will get clarifying guidance on this critical issue.

Still, even without the 70% Suspension Interpretation, the WCSH is a tool that every QOZB should use to its full advantage. The WCSH opens the door to the 62-Month Safe Harbor, which is a powerful set of rules that can help start-up QOZBs get their projects underway without fear of a foot fault on the Tangible Property Requirement, the Intangible Property Requirement and the Gross Income Requirement. And if the 70% Suspension Interpretation is correct, then the WCSH can be a true golden ticket for some start-up QOZBs with otherwise initially non-qualifying projects that need a runway to get their real estate businesses off the ground.

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The D&S Opportunity Zones team is keeping tabs on the latest developments. Reach out to any member of the team in the meantime if you would like to discuss your particular project or QOF.

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