

34th Annual Tax Symposium

THE WIZARD OF (Q)OZ

RURAL RICHES AND URBAN UPSIDES IN QUALIFIED OPPORTUNITY ZONES

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I. KEY CONCEPTS AND TERM

- A. Qualified Opportunity Zone (QOZ) and designation mechanics.
 - 1. Qualified Opportunity Fund (QOF), Qualified Opportunity Zone Business (QOZB), and QOZ Business Property (QOZBP).
 - a. Original use vs. substantial improvement.
 - b. Active conduct of a trade or business.
 - c. Nonqualified financial property limits.
 - 2. Safe harbors and timing rules.
 - a. Working capital safe harbor and 31-month deployment periods.
 - b. 180-day reinvestment rules for different taxpayer profiles.
 - c. Ten-year basis election mechanics and exit considerations.
 - 3. Reporting and penalties.
 - a. Asset, employment, NAICS, and tract-level reporting data.
 - b. Penalty tiers and willful non-compliance.
 - c. Audit documentation and retention standards.

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4. Gross income requirement tests:
 - a. Hours: if at least 50% of the services, based on hours performed for the QOZB by its employees and contractors, are within an OZ
 - b. Compensation: if at least 50% of the compensation for services performed for the QOZB by its employees and contractors is paid for services performed within an OZ
 - c. Property and Management: if the tangible property of the QOZB in an opportunity zone and the management or operational functions performed for the QOZB in an OZ are each necessary to generate 50% of the gross income of the QOZB
 - d. “Facts and Circumstances”- a catchall for any other situation where the business *should* meet the 50% requirement (but does not under the other three tests. This should be a last resort.

II. OVERVIEW AND LEGISLATIVE FRAMEWORK

- A. Statutory origin and policy intent
 1. Creation under federal tax reform and codification in the Internal Revenue Code as a place-based incentive to channel private capital into low-income census tracts via Qualified Opportunity Funds (QOFs).
 - a. State nomination and Treasury certification of zones.
 - b. Time-limited nature of the original program with a hard recognition date for deferred gain and a 10-year holding election to exclude post-acquisition appreciation.

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- c. Policy objectives: accelerate development, broaden investment access, and spur job creation, while balancing anti-abuse safeguards.
- 2. Core definitions and program architecture
 - a. Qualified Opportunity Zone (QOZ), Qualified Opportunity Fund (QOF), and Qualified Opportunity Zone Business (QOZB).
 - b. Qualified Opportunity Zone Business Property (QOZBP) and the “original use” versus “substantial improvement” standards.
 - c. Active conduct of a trade or business, limitations on nonqualified financial property, and prohibited “sin businesses.”
- 3. Program lifecycle and key dates
 - a. 180-day reinvestment periods for eligible gain and partner-level timing variations.
 - b. December 31, 2026 recognition of deferred gain under the original program mechanics.
 - c. Ten-year basis adjustment election for appreciation on QOF interests
- B. Tax benefits and mechanics under QOZ 1.0
 - 1. Gain deferral and basis step-ups
 - a. Deferral of eligible gain invested in a QOF until the earlier of disposition or December 31, 2026.
 - b. Historical basis step-ups tied to five- and seven-year holding periods for early investors and their transition status.

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- c. Permanent exclusion of post-investment appreciation in a QOF interest after a qualifying 10-year hold through elective basis adjustments.
- 2. Investment flow and structuring
 - a. Contribution of eligible capital gain into a QOF within the prescribed time period.
 - b. QOF-level deployment into QOZB equity or QOZBP to satisfy asset tests and timing safe harbors.
 - c. Use of subsidiary QOZBs, working capital safe harbor planning, and development/operating business models.
- 3. Illustrative transaction paths
 - a. Real estate development with substantial improvement versus original use assets.
 - b. Operating business investments and the “active conduct” substantiation expectations.
 - c. Mixed-use projects and layered capital stacks, including debt, tax credits, and municipal incentives (e.g. TIF, LIHTC, OPRA, etc.).

III. COMPLIANCE ARCHITECTURE FOR QOFS AND QOZBS

- A. Threshold tests for QOZBs
 - 1. Gross income sourcing from active conduct in the zone
 - a. Alternative tests: hours, compensation, property-and-management, and facts-and-circumstances.

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- b. Documentation practices to demonstrate ongoing compliance.
 - c. Treatment of service, retail, and distributed workforce models.
 - 2. Tangible property tests and “substantial improvement”
 - a. The 70% QOZBP standard at the QOZB level and “substantially all” use within a QOZ.
 - b. Doubling-of-basis rule, measurement periods, and construction/rehab timelines.
 - c. Leased property and valuation considerations for owned versus leased assets.
 - 3. Intangible property and nonqualified financial property limits
 - a. 40% use of intangibles in active conduct within the zone.
 - b. Less-than-5% average unadjusted basis in nonqualified financial property.
 - c. Working capital safe harbor alignment to preserve compliance.
- B. QOF-level requirements and reporting
 - 1. Asset testing and timing
 - a. Biannual testing mechanics and interaction with working capital plans at the QOZB level.
 - b. Consolidation of QOZB equity and direct property holdings for compliance.
 - c. Consequences of asset test failures and remedial strategies.

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2. Documentation and annual reporting
 - a. Asset composition, property ownership and leasing detail, and classification by NAICS and census tract.
 - b. Employment metrics, residential unit counts for real estate portfolios, and subsidiary investment disclosures.
 - c. Evolving federal reporting standards, data completeness, and verification expectations.
3. Penalties and enforcement posture
 - a. Monetary penalties scaled by QOF size and the threshold for “willful” non-compliance.
 - b. Process control frameworks to mitigate reporting risk.
 - c. Regulator priorities and the evidentiary record for examinations.

IV. QOZ 2.0: STRUCTURE, COMPLIANCE, AND TRANSITION

- A. Core programmatic changes
 1. Duration and timing
 - a. Transition from the expiring 2017-era framework to a permanent program on a rolling 10-year basis beginning in 2027.
 - b. Rolling deferral mechanics and alignment with the 10-year exclusion election.
 - c. Implications for fund life, asset hold periods, and exit planning.

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2. Basis and exclusion
 - a. Elimination of the prior seven-year bonus framework and revised five-year 10% step-up.
 - b. Preservation of the 10-year exclusion of post-investment appreciation.
 - c. Modeling investor after-tax IRR with new step-up and deferral features.
 3. Rural-focused vehicles
 - a. Creation of specialized rural funds and designation of rural QOZs with more relaxed parameters.
 - b. Incremental basis step-up (up to 30%) to encourage rural deployment.
 - c. Development feasibility and sponsor capabilities in low-density markets.
- B. Compliance and reporting under QOZ 2.0
1. Expanded annual reporting
 - a. Asset values, property details by ownership/lease, and tangible/intangible mix.
 - b. Residential unit counts, FTE tracking, NAICS coding, and tract-level identification.
 - c. Subsidiary investments and intercompany arrangements.

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2. Active business requirement and timelines
 - a. Affirmative demonstration of “active conduct” at QOF or QOZB level.
 - b. 31-month deployment windows, extensions, and coordination with working capital safe harbors.
 - c. Impacts on ground-up development versus operating business expansions.
3. Penalty regime
 - a. Tiered penalties for small and large QOFs and heightened sanctions for willful non-compliance.
 - b. Internal controls, attest readiness, and third-party verification practices.
 - c. Data architecture to support auditable reporting.
- C. Open questions and guidance agenda
 1. Re-designation and legacy investments
 - a. Decennial re-designation beginning in 2026 and the procedural role of governors and treasury.
 - b. Treatment of existing investments when census tracts are re-scoped or rotated out.
 - c. Transition relief and grandfathering mechanics to avoid cliff effects.
 2. 2026 recognition and rollover pathways
 - a. Confirmation of gain recognition procedures on December 31, 2026 for QOZ 1.0 deferrals.

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- b. Potential avenues, if any, to rollover into QOZ 2.0 frameworks and preserve tax benefits.
 - c. Reporting mechanics and taxpayer elections at the transition juncture.
- 3. Implementation timetable
 - a. Anticipated delays in guidance due to federal administrative constraints.
 - b. Expected sequencing: interim guidance, proposed regulations, and final rules.
 - c. Planning amid uncertainty: conservative interpretations and flex provisions.

V. TRANSACTION PLANNING AND RISK MANAGEMENT

A. Design and diligence

- 1. Project selection and underwriting
 - a. Market fundamentals, tenant demand, and cap-ex scheduling aligned with compliance mile-stones.
 - b. Zoning, entitlements, and construction delivery risk.
 - c. Sensitivity to interest rate, cost inflation, and exit valuation risks.
- 2. Structural considerations
 - a. Direct QOF property investment versus QOZB subsidiary structures.
 - b. Leveraging working capital safe harbors, reinvestment rules, and casualty/claim proceeds.

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- c. Partner-level elections and timing coordination for flow-through taxpayers.
- 3. State tax conformity
 - a. Divergent state treatments of QOZ deferral and exclusion benefits.
 - b. SALT planning for residents and nonresidents.
 - c. Withholding, apportionment, and composite return considerations.
- B. Common pitfalls
 - 1. Qualification slippage
 - a. Failing asset tests or active conduct requirements due to timing or documentation lapses.
 - b. Misapplication of substantial improvement rules and original use determinations.
 - c. Excess nonqualified financial property and working capital misalignment.
 - 2. Reporting and substantiation
 - a. Incomplete data capture for property, employment, and business activity.
 - b. NAICS and tract-level misclassification risks.
 - c. Inadequate internal control environments for scalable reporting.

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3. Exit strategy and compliance tail
 - a. Managing 10-year exit mechanics and basis elections.
 - b. Sales of assets versus interests and the consequences for exclusion claims.
 - c. Post-exit audits and retention of records.