MEMO

Subject: **Opportunity Zones – Aggregation of Assets for Purposes of the Substantial Improvement Test**
From: **John Lettieri, President & CEO, Economic Innovation Group**
Date: **September 20, 2019**

Background

Section 1400Z-2, added by Public Law 115-97 (the Tax Cuts and Jobs Act), provides tax incentives for investors to make equity investments in qualified opportunity funds (QOFs) that will in turn invest in qualified opportunity zone business property (QOZ Business Property), either directly or indirectly through qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs). To qualify as QOZ Business Property, tangible property must be acquired by the entity after December 31, 2017 by purchase from an unrelated person, and either its original use in the QOZ commences with the QOF or QOZ Business or the QOF or QOZ Business substantially improves the property.[1] If held through a QOZ Business, "substantially all" of the tangible property must constitute QOZ Business Property.[2]

Property is treated as substantially improved "only if, during any 30-month period . . . additions to basis with respect to such property in the hands of the qualified opportunity fund [or QOZ Business] exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period . . . ."[3]

The Problem: Asset-by-Asset Application of the Substantial Improvement Test Is Unworkable for Operating Businesses

The preamble to the May 2019 proposed regulations states that the substantial improvement requirement is applied on an asset-by-asset basis.[4] However, this requirement would be nearly impossible for operating businesses to satisfy and does not reflect the manner in which businesses typically expand, add value, or increase their economic activity. Many assets, such as equipment or office furniture, do not easily lend themselves to substantial improvement through a more than doubling of basis. Furthermore, the recordkeeping and compliance requirements for asset-by-asset application of the substantial improvement test to an operating business would be extremely burdensome.

Consider a simplified example where a QOZ Business starts a new restaurant business in a QOZ. Because of budget constraints, the QOZ Business decides to refurbish equipment that

[1] I.R.C. § 1400Z-2(d)(2)(D)(i); Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i)(A), (C).

[2] I.R.C. § 1400Z-2(d)(3)(A)(i). For this purpose, the proposed regulations define "substantially all" as 70 percent of the tangible property. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(1)(i), (d)(3).

[3] I.R.C. § 1400Z-2(d)(2)(D)(ii), (d)(3)(A)(i). *Compare* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(8)(i) and -1(d)(4), which inexplicably remove the phrase "with respect to such property" in stating the 30-month safe harbor.

[4] 84 Fed. Reg. 18,652, 18,655, *Explanation of Provisions*, § I.B. (May 1, 2019).

has previously been used in the QOZ, so it cannot rely on the original use test. The QOZ Business acquires three ovens for $4,000 each, two refrigerators for $3,000 each, and twenty tables for $500 each. Two of the ovens end up needing extensive improvements of $10,000 each, while the third only needs $3,000 of improvements. One refrigerator requires $6,000 of improvements while the other requires $2,000. Each table requires $250 of improvements.

Overall, the QOZ Business acquired the assets for $28,000 and spent $36,000 on improvements. However, when viewed on an asset-by-asset basis, only two of the ovens and one of the refrigerators has been substantially improved. These assets represent less than 70 percent of the value of the tangible assets, and so the QOZ Business flunks the substantially all requirement.

<u>Recommended Aggregation Approach</u>

We recommend that the final regulations adopt an aggregation approach and permit businesses to adopt one of two safe harbors to aggregate certain related assets for purposes of determining whether assets have been substantially improved.

- Investment Decision Safe Harbor[5]
    - Under this safe harbor, assets of a QOZ that are purchased as part of the same investment decision and are part of the same trade or business would be treated as an aggregate asset for purposes of measuring substantial improvement.
    - The Investment Decision Safe Harbor should be limited to operating businesses in order to prevent potential abuses by QOFs or QOZ Businesses that purchase multiple adjacent parcels with the intent to only improve one of them.
    - The same trade or business limitation is intended to prevent a similar ability on the part of operating businesses to acquire multiple businesses and improve or expand only one of them.
    - All assets acquired as part of the same investment decision, including those assets that are not actually improved (such as new assets that are acquired as part of the same investment decision) should be aggregated. In addition, all expenditures to improve those assets that are improved (even if it would not qualify as substantial with respect to that particular asset) and all expenditures to acquire those assets that are not improved should be aggregated.

[5] A variation of this safe harbor was also recommended by the American Bar Association (ABA) Section of Taxation. ABA Section of Taxation, *Comments on Proposed Regulations Regarding Investment in Qualified Opportunity Funds Under Section 1400A-2*, at 39-42 (Jan. 10, 2019).

- Section 1250 Property Safe Harbor[6]
    - Under a second proposed safe harbor, assets would be aggregated if they would meet the "integrated unit" test for treatment as a single item of section 1250 property.[7]
    - Under this safe harbor, structures may be aggregated if they are "operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting)."
    - Similar to the Investment Decision Safe Harbor, all assets operated as an integrated unit, including those assets that are not actually improved (such as new assets that are acquired and operated as an integrated unit), should be aggregated. In addition, all expenditures to improve those assets that are improved (even if it would not qualify as substantial with respect to that particular asset) and all expenditures to acquire those assets that are not improved should be aggregated.
    - This safe harbor would apply to both operating and real estate businesses, as we believe the integrated unit limitation would prevent potential abuses associated with the purchase multiple adjacent parcels with the intent to only improve one of them.
- Either of these safe harbors would solve the problem for the restaurant business in the example above. Because the QOZ Business purchased the ovens, refrigerators, and tables as part of a single investment decision, and they are operated as an integrated unit, they would be treated as a single asset acquired for $28,000. The QOZ Business would be treated as making $36,000 in improvements to this aggregate asset, which would, accordingly, be treated as substantially improved.
- By creating safe harbors, rather than mandatory aggregation rules, operating businesses would not be forced into using asset aggregation. An elective approach is important because there are situations in which it may not make sense to aggregate assets.

<u>An Aggregation Approach is Consistent with Both the Purpose and Language of the Statute</u>

- When the QOZ incentive was originally introduced in Congress as the "Investing in Opportunity Act," the bill was intended to "create new channels for investment in small businesses, support entrepreneurs, develop blighted properties."[8]
- The substantial improvement test was likely included in the statute in order to encourage the improvement of existing property in the QOZ and ensure that new economic activity and investment is made in the QOZ for businesses that already own property.

---

[6] This safe harbor was similarly recommended by the ABA Section of Taxation. *Id.*

[7] *See* Treas. Reg. § 1.1250-1(a)(2)(ii). Although section 1250 applies only to certain depreciable real property, this safe harbor should apply to any tangible property that meets the integrated unit test, regardless of whether such property constitutes "section 1250 property" as that term is defined in section 1250(c).

[8] "Senator Scott Introduces the Bipartisan Investing in Opportunity Act," (Feb. 2, 2017), https://www.scott.senate.gov/media-center/press-releases/senator-scott-introduces-the-bipartisan-investing-in-opportunity-act.

- The Department of the Treasury and the Internal Revenue Service recognized the need for more flexible rules to achieve the purposes of the statute and requested comments on the potential advantages and disadvantages of adopting an aggregate approach for substantial improvement:

> *The Treasury Department and the IRS have considered the possibility, however, that an asset-by-asset approach might be onerous for certain types of businesses. For example, the granular nature of an asset-by-asset approach might cause operating businesses with significant numbers of diverse assets to encounter administratively difficult asset segregation and tracking burdens, potentially creating traps for the unwary. As an alternative, the Treasury Department and the IRS have contemplated the possibility of applying an aggregate standard for determining compliance with the substantial improvement requirement, potentially allowing tangible property to be grouped by location in the same, or contiguous, qualified opportunity zones. Given that an aggregate approach could provide additional compliance flexibility, while continuing to incentivize high-quality investments in qualified opportunity zones, the Treasury Department and the IRS request comments on the potential advantages, as well as disadvantages, of adopting an aggregate approach for substantial improvement.*[9]

- An aggregate approach is more consistent with the language of the statute referring to additions to basis "with respect to such property," which suggests a more flexible approach than "of the property" adopted by the proposed regulations.
- The aggregation approach is consistent with the purposes of the QOZ statute to encourage investment in small, entrepreneurial businesses, which tend to be operating businesses. One key advantage of an aggregation approach is that operating businesses could satisfy the QOZ Business Property requirements even if they previously owned and used equipment in the QOZ as long as substantial new investment is made in the property, which is precisely what Congress intended. Without such a rule, operating businesses will be forced to newly lease or purchase their equipment solely to become eligible to receive QOF investment, even if business considerations dictate otherwise. Similarly, real estate development businesses may be forced to acquire multiple structures that will be operated as a functional unit, such as an office building and parking garage, in separate entities, which is inefficient and serves no policy goal.
- The aggregation approach also avoids potential burden with an overly granular approach to defining an asset. For example, should various systems and fixtures be treated as separate assets? What about materials and supplies? The administrative burden of an asset-by-asset approach would be enormous for businesses and the IRS alike, and would lead to outcomes contrary to the purpose of the law.

[9] 84 Fed. Reg. at 18,655, *Explanation of Provisions*, §I.B.