The Tangible Property Test

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Since coming into effect in January 2018, Subchapter Z of the US Tax Code—also known as the opportunity zone provisions—has enabled investors to pour billions of dollars into a broad array of businesses, from real estate development companies to tech startups. Investments in qualified opportunity funds (QOFs) offer a number of distinct tax benefits, not the least of which is reduced capital gains tax liability. But the rules governing these investments are quirky, perplexing and—in some cases—severely restrictive.

For an entity to be considered a qualified opportunity zone business (QOZB), at least 70% of its tangible property must be qualified opportunity zone (QOZ) property. In this sixth in our series of articles on qualified opportunity funds (QOFs), we discuss the tangible property test in detail.

As mentioned in a previous article, among other requirements for an entity to be considered a qualified opportunity zone business (QOZB), it must meet the tangible property test.

A QOZB partnership or QOZB corporation satisfies the tangible property test if substantially all of the tangible property of the entity is QOZB property. For these purposes, “substantially all” means 70% (Prop. Reg. §1.1400Z(d)-1(d)(3)(i)).

Tangible property is QOZB property if it is (1) used in the active conduct of a trade or business physically located in a qualified opportunity zone (QOZ); (2) acquired by a QOZB after December 31, 2017, from an unrelated party; and (3) either (a) the original use of such property in the QOZ began with the QOZB (the **original use test**) or (b) the QOZB substantially improves such property (the **substantial improvement test**) (Section 1400Z-2(d)(2)(D)(i)).

The tangible property test limits its scope to the proportion of tangible property that is QOZB property. In other words, the numerator is the value of tangible property that qualifies as QOZB property and the denominator is solely all of an entity’s tangible property (not all of its assets).

Measurement of Value

In general, for purposes of determining whether an entity satisfies the tangible property test to qualify as a QOZB, the entity may measure its tangible assets using one of two methods (Treas. Reg. § 1.1400Z2(d)-1(b)(1)): the **applicable financial statement valuation method** (Treas. Reg. § 1.1400Z2(d)-1(b)(3)) or the **alternative method** (Treas. Reg. § 1.1400Z2(d)-1(b)(4)). Whichever method of measurement the QOZB chooses for a given tax year, that method must be applied consistently to all of the QOZB's tangible property (Treas. Reg. § 1.1400Z2(d)-1(b)(2)(ii)(A)).

The applicable financial statement valuation method allows the entity to use the book value of the asset as shown on an applicable financial statement (within the meaning of Treas. Reg. § 1.475(a)-4(h)) for the relevant period. With respect to leased property, this method is only available if the applicable financial statement follows generally accepted accounting principles (GAAP) and requires an assignment of value to the leased property. (In this context, leased property means property with respect to which the QOZB or QOF is lessee. This does not include property for which the QOZB or QOF is lessor.)

If a QOZB has no applicable financial statement or chooses not to use the applicable financial statement valuation method, it must use the alternative method. Under the alternative method, the value of property owned by the entity is measured by its unadjusted cost basis if purchased or constructed for fair market value or, if acquired for less than fair market value, the asset's fair market value, determined on the last day of the first six-month period of the taxable year and on the last day of the taxable year (Treas. Reg. § 1.1400Z2(d)-1(b)(4)(ii)). If property is leased, then the property is valued at the present value of the discounted future payments under the lease (Treas. Reg. § 1.1400Z2(d)-1(b)(4)(iii)).

Thus, for purposes of the tangible property test, property generally will be measured either by its book value, cost basis, fair market value, or the value of discounted cash outlays with respect to leases. The values generally will be fixed for the duration of the holding period of the asset, save possibly for a revaluation if the applicable financial statement valuation method is used.

Example Computation

Tangible Property	Unadjusted Basis	Book Value (per AFS)
A	$25	$90
B	$15	$20
C	$10	$20
Total	$50	$130

As an example, assume that a QOZB has the balance sheet described above. Using the alternative valuation method, its total tangible property would have a value of $50. This would be the denominator in the ratio for the tangible property test. If asset A were QOZB property (for example, because original use of asset A in the QOZ began with the QOZB), but not assets B or C, then the ratio would be $25/$50, or 50%, and the QOZB would not satisfy the tangible property test. If instead, asset B was also QOZB property (for example, because the QOZB had substantially improved asset B), then the ratio would be $35/$50, or 70%, and the QOZB would satisfy the tangible property test.

Considering the same balance sheet and using the applicable financial statement valuation method this time, the QOZB's total tangible property would have a value of $120. If asset A was QOZB property, but not assets B or C, then the ratio would be $90/$120, or 75%, and the QOZB would satisfy the tangible property test.

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