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Client Alert

Tax

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IRS and Treasury Release Final Opportunity Zone Regulations

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INTRODUCTION

On December 19th, 2019, the Department of the Treasury and the Internal Revenue Service (the “IRS”) issued regulations (the “Final Regulations”) under Section 1400Z-2 of the Internal Revenue Code (the “Code”)[1] finalizing, with modifications, two rounds of previously-proposed regulations issued in October 2018 and May 2019 (collectively, the “Proposed Regulations”). The “qualified opportunity zone” (“QOZ”) provisions were initially enacted as part of the 2017 tax reform bill, aiming to provide taxpayers with the ability to defer recognition of certain investment gains by timely investing such gains in a qualified opportunity fund (“QOF”). A QOF, in turn, is subject to a requirement that 90% of its assets constitute “qualified opportunity zone property” (“QOZP”), which includes subsidiary entities that constitute “qualified opportunity zone businesses” (“QOZBs”). The potential tax benefits of a properly-structured investment in a QOF include the deferral of tax (until December 31, 2026) on eligible gains, partial exclusion of such gains if certain holding periods are achieved, and the elimination of all post-investment gain (attributable to appreciation in the QOF investment) so long as a ten-year holding period requirement is met.

It is apparent from the Preamble to the Final Regulations (the “Preamble”)[2] that the IRS gave serious consideration to the numerous comments submitted in response to the Proposed Regulations. As a result, although they contain many nuances and subtleties, the Final Regulations provide clarity and relative certainty on a number of issues crucial to both investors and businesses seeking the tax benefits of the QOZ program. According to the Preamble, “the Treasury Department and the IRS anticipate that this clarity generally will encourage taxpayers to invest in QOFs and will increase the amount of investment located in QOZs.” We believe that this characterization will prove to be accurate and that QOZ investment activities will see a meaningful uptick in 2020. In fact, the very issuance of “final” regulations is itself an important element in reducing market uncertainty. To be sure, however, uncertainties remain, and interpretive ambiguities surrounding key concepts will inevitably emerge as taxpayers

begin to apply the Final Regulations. This summary highlights several important provisions of the Final Regulations which are likely to be most critical to stakeholders, with an emphasis on the provisions that represent a departure from the Proposed Regulations as well as the rules most directly applicable to real estate investments. This summary also assumes some degree of basic familiarity with the QOZ rules and forgoes a general introductory explanation.

OBSERVATIONS

Section 1231 Gains. The Final Regulations depart from the Proposed Regulations and provide that, for purposes of determining the amount of eligible gains, Section 1231 gains (typically gains from the sale of property used in a trade or business) will be calculated on a *gross* basis, without regard to the Section 1231 losses for the taxable year. In other words, Section 1231 gains need not be netted against Section 1231 losses.[3] As a result of this gross treatment, the 180-day window for investing qualified Section 1231 gains begins on the date of the sale or exchange that gave rise to such gains (as opposed to waiting until the end of the applicable taxable year). The treatment of Section 1231 gains was an area that received a lot of attention and in which the IRS considered many varying approaches. The Final Regulations create welcome uniformity amongst different categories of capital gains. It should be noted, however, that Section 1231 still contains various operating rules that must be applied. For example, the rules governing “net unrecaptured 1231 losses” contained in Section 1231(c) will apply upon the triggering of deferred Section 1231 gains.[4] Additionally, in determining the net Section 1231 amounts for a taxable year, gains deferred under Section 1400Z-2 are ignored.

Flow-through Gains. Under the Proposed Regulations, taxpayers that realized eligible gains through pass-through entities such as partnerships or S corporations had the option to utilize either the 180-day period beginning on the date of the gain realization, or the 180-day period beginning on the last day of the taxable year of the entity. The Final Regulations add yet another “window” to the mix – specifically, partners in a partnership, shareholders of an S corporation, and beneficiaries of estates and trusts now have the option to start the 180-day reinvestment period on the due date of the entity’s tax return, not including any extensions. Investors forced to wait for Schedule K-1s now have additional time to make a qualifying investment. For typical calendar year partnerships, partners will now have access to the 180-day window that begins on March 15 of the year following the taxable year of the gain.

Transfers of Property to QOFs and QOZBs. The Final Regulations provide that eligible gain does not include gain realized upon a transfer of property to a QOF in exchange for an eligible interest. In the Preamble, the IRS describes the possible application of step transaction principles to a transaction in which a taxpayer sells property to a QOF (or a qualified opportunity zone business, a “QOZB”), followed by an investment of the proceeds in the QOF. Such transactions will have to be structured carefully, and in a manner that does not implicate the step transaction doctrine. The discussion contained in the Preamble is somewhat ambiguous as to whether this “circular cash flow” issue applies only where the transferor receives sufficient equity to become a related person, or whether it applies irrespective of the resulting ownership percentage. It should be noted that these considerations are not only relevant to the eligibility of gain triggered as a result of the transfer, but also to the status of the transferred property itself as qualifying property, since Section 1400Z-2 requires that qualifying property be purchased (as determined under Section 179), and not contributed in a carryover basis transaction.

Installment Sale Gains. Taxpayers realizing capital gains under the installment method will have two options when determining the 180-day investment period. First, they may utilize the period beginning on the date a payment is received. Alternatively, they may start the clock on the last day of the taxable year in which the eligible installment sale gain would be recognized. This rule provides welcome flexibility to taxpayers receiving payments under installment obligations or various types of earnout or deferred consideration events. Interestingly, installment sale gains may be deferred even if the sale itself occurred prior to the enactment of Section 1400Z-2.

Restructurings and Inclusion Events. Like the Proposed Regulations, the Final Regulations provide that a transfer of a direct or indirect interest in a QOF to a transferee partnership in a Section 721 transfer is not an inclusion event, provided there is no termination of the transferred partnership for U.S. federal income tax purposes. In these cases, the transferee partnership "steps into the shoes" of the eligible holder for all purposes of the QOZ rules, including making the election under Section 1400Z-2(c) to exclude from gross income gains and losses from the disposition of the QOZ investment after ten years. The transferee partnership will allocate the basis adjustments and other items using forward and reverse Section 704(c) principles. The ability to contribute QOF interests to "aggregator" or "feeder" partnerships will be useful to taxpayers holding interests in different QOFs. Perhaps more importantly, the Final Regulations permit mergers of QOF partnerships under Section 708(b)(2)(A), so long as the resulting partnerships are QOFs. Consequently, such a transaction will not constitute an inclusion event to a partner that receives only a partnership interest in the resulting partnership. This ability to merge QOF partnerships is a welcome innovation under the Final Regulations and should permit sponsors who have previously established parallel fund structures to combine these entities, subject to the discussion immediately below regarding exit structuring.

Exit Structuring. One of the key challenges arising from the Proposed Regulations was the uncertainty surrounding the required exit structure. The Proposed Regulations did not give taxpayers certainty on any transactional form outside of a sale of interests in a QOF, which in many cases gave rise to transaction costs and unwieldy fund structures. Such constraints have also resulted in the proliferation of "single asset funds." The Final Regulations expand the scope of gains which an investor may elect to exclude from income. Specifically, with the exception of gain from the sale of inventory, all gains from the sale of property by a QOF partnership or by a QOZB partnership are eligible for exclusion as long as the qualifying investment in the QOF has been held for at least ten years. This expanded rule is highly significant for a number of reasons. First, *all* gains (other than inventory gains) are eligible for the gain exclusion. This means that ordinary gains, including depreciation recapture, are covered by the Final Regulations as well. Moreover, gains attributable to property that is not QOZP are exempt as well. Finally, the exclusion applies to sales at any of the levels of a typical two-tier structure – that is, sales of QOF interests by an eligible investor, sales of QOZB interests by a QOF, and sales of qualifying property by a QOZB. Funds that hold multiple properties should now be able to hold them through a single QOF, which may hold the properties through multiple QOZBs, or even all in a single QOZB.[5] However, funds that accept investor contributions in stages over extended investment periods may still face certain challenges in planning timely exits.

Recycling of Assets. As described above, the Final Regulations seek to minimize the artificial distinctions that arose under the Proposed Regulations between sales at the investor level and sales at the entity level after a minimum ten-year holding period is achieved. However, another important consideration for investors is the treatment of asset sales and other monetization events prior to year ten, which often result in "inclusion events" with respect to the initially deferred gain. The Final Regulations go further than the Proposed Regulations and permit a taxpayer to defer gain that would otherwise be triggered as a result of a complete *or partial* disposition of an interest in a QOF by investing within 180 days in a different QOF, provided that all of the requirements for deferral are met. The holding period of the new QOF investment begins at the time of such investment. In terms of recycling and reinvestment of sales proceeds at the entity level, the Final Regulations preserve the rule allowing a QOF to reinvest sales proceeds within a 12-month period without adversely impacting QOF qualification. This rule does not apply at the QOZB level. Further analysis is required with respect to the treatment of any taxable gain realized in connection with a sale of assets by a QOF or QOZB partnership prior to an investor's ten-year hold period.

Profits Interests. The Final Regulations, as expected, reaffirm that QOF interests received for services are not eligible interests. However, in determining the proper "allocation percentage" applicable to such an interest (namely, where it comprises part of a "mixed fund" investment together with an interest received in exchange for eligible gains), the Final

Regulations state that the percentage with respect to the profits interest is based on the share of residual profits associated with that interest, "disregarding any allocation of residual profits for which there is not a reasonable likelihood of application."[6] Although not entirely clear from the Preamble, this rule appears to be a reaction to the numerous comments received in response to the Proposed Regulations, which could have been read to require an allocation percentage higher than the actual share of profits associated with the profits interest. Although this clarification is helpful, we believe that it may still be advisable for sponsors to keep their "promote" or profits interest separate from any eligible interest held in a QOF partnership.

Basis Step-Ups. The Final Regulations clarify that the five- and seven-year basis adjustments to a qualifying investment in a QOF partnership give rise to tax basis for all purposes, including freeing up suspended losses under Section 704(d). Furthermore, where a partner of a QOF partnership sells its QOF interest after a minimum ten-year hold and elects to adjust its basis under Section 1400Z-2(c), the basis step-up includes the partner's share of QOF partnership debt under Section 752. The inside basis of the assets of the QOF partnership (and any lower-tier partnership) is also adjusted in a manner similar to the Section 743(b) adjustments that would have been made if the transferor QOF partner had purchased its interest in the QOF partnership for cash equal to the fair market value of the interest immediately prior to the sale or exchange, assuming that a valid Section 754 election had been in place.

QOF Testing Dates. For the first taxable year in which an eligible entity has in effect an election to self-certify as a QOF, the first testing date occurs at the end of the six-month period beginning with (and including) the month in which the QOF election is effective. This means that a QOF that has an inception in June will have a testing date at the end of November, and then again on December 31. This rule has caused some confusion amongst taxpayers, since the initial period in most cases is less than six months. The Final Regulations do not change this result. However, as discussed below, the Final Regulations also provide a QOF the ability to ignore recently contributed cash for a full six-month period.

Grace Period for New QOF Capital. The Final Regulations expand upon a rule introduced in the May 2019 Proposed Regulations, allowing a QOF to exclude recently contributed property from both the numerator and denominator of the 90% asset test for a full six-month period so long as (1) the property is received as a contribution to the QOF solely in exchange for an interest in the QOF, and (2) during such period (other than the first five days after receipt of such property) the amount is held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less. This grace period rule is proving to be extremely helpful to QOFs that are in their startup period, are negotiating joint venture investments, or otherwise need additional time to deploy invested cash – especially cash contributions made shortly before a semiannual testing date. A question has arisen as to the proper treatment of a QOF that holds, as of a testing date, nothing other than cash that is excluded pursuant to this rule. Although not entirely clear, the discussion of this rule in the Preamble may suggest that an undefined fraction will not cause a QOF to fail the 90% asset test (at the very least the first such test).

Six-Month QOZB Cure Period. The Final Regulations contain a six-month period for an entity in which a QOF has invested to cure a defect that caused the entity to fail to qualify as a QOZB. This cure period can be used only once and is in addition to any "reasonable cause" penalty exceptions that would apply to a QOF.

Disguised Sale Issues. The Final Regulations confirm that an interest in a QOZB must be acquired by a QOF "from the partnership" (in the case of a QOZB partnership) or "from the corporation" (in the case of a QOZB corporation), in each case solely in exchange for cash. QOFs that are investing in a QOZB partnership after the QOZB is established must be sure that the cash invested is not recharacterized under Subchapter K as a disguised purchase of QOZB equity from another QOZB member. In such a case, there is a risk that the interest acquired is not a qualifying asset under the 90% asset test for the QOF.

Working Capital Safe Harbor. Perhaps the most notable innovation of the Final Regulations for real estate development is the expansion of the safe harbor for reasonable working capital. This safe harbor is critical because it allows a QOZB[7] to avoid violating the 5% nonqualified financial property limitation in Section 1397C(b)(8) (via Section 1400Z-2(d)(3)(A)(ii)) during a deployment period, as well as avoid the need to separately comply with certain components of the QOZB asset and income tests during such period. Under the Proposed Regulations, the period was 31 months, and was eligible to be tolled in the event of certain governmental delays. The Final Regulations provide for a 62-month safe harbor period, which is comprised of two successive 31-month periods (as opposed to a straightforward grant of 62 months), each of which must independently satisfy the basic requirements of the safe harbor. The QOZB must demonstrate that it meets certain qualitative and quantitative requirements, such as the need for a subsequent cash infusion and a working capital plan that properly reflects such additional infusion. It should be noted that 62-month period is the maximum duration of time that any taxpayer may have to ensure the property is compliant with the QOZ rules, and the clock begins on the date of the first cash infusion covered by the safe harbor. A governmental delay will not toll the safe harbor unless it poses a substantial obstacle for improving such tangible property, but the Final Regulations do not clarify what constitutes a "substantial obstacle." Furthermore, the Final Regulations provide additional clarity with respect to the treatment of in-progress assets and income generated from the "insulated" working capital for purpose of the other QOZ requirements. Taxpayers will have more flexibility in structuring longer term real estate development projects under the expanded safe harbor of the Final Regulations. However, the Final Regulations only contain one true example of a project that utilizes a period greater than 31 months, with somewhat simplified facts. Consequently, the precise application of the rule to a project that involves multiple cash infusions and a fluid budget and timeline is less than perfectly clear and will require careful planning, analysis, and documentation.

Substantial Improvement and Ancillary Property. The Final Regulations relax somewhat the strict "asset by asset" approach to substantial improvement contained in the prior guidance. First, the cost of purchased property can count toward the substantial improvement of non-original use property if it is in the same QOZ, used in the same trade or business, and improves the functionality of such property. When a taxpayer utilizes this rule, it must also improve the non-original use property by more than an insubstantial amount. The Final Regulations offer an example involving a hotel that is acquired for $4 million (excluding land). The QOF spends $1.5 million on structural renovations to the hotel, but another $2.5 million on linens, mattresses and furniture, as well as new exercise equipment and a restaurant attached to the hotel. In this example, the $2.5 million counts towards substantial improvement of the hotel, and is not separately treated as original use property.

Substantial Improvement and Building Groups. Second, the Final Regulations set forth a specific aggregation rule whereby certain buildings can be aggregated and treated as a single item of property. All buildings that comprise an "eligible building group" and that sit on a parcel of land described in a single deed may be treated as a single property. All buildings in an eligible building group that sit on contiguous parcels of land described in separate deeds may be treated as a single property to the extent each building is operated as part of one or more trades or businesses, provided that (1) the buildings must be operated exclusively by the QOF or by the QOZB; (2) the buildings must share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and (3) the buildings must be operated in coordination with, or reliance upon, one or more of the trades or businesses. This expanded rule may allow developers to include certain assemblages in a QOZ compliant structure whereas under the Proposed Regulations certain of the structures had to be held separately.

Original Use and Vacancy. The Proposed Regulations contained a five-year vacancy period in order to meet the "original use" test for real estate. The Final Regulations relax this rule and provide that property that had been vacant for one year before the designation of the applicable QOZ as such, and that continued to be vacant through the date or

purchase, will constitute original use property. For property that was not vacant for this one-year period but becomes vacant thereafter, a three-year vacancy period is required. The Final Regulations provide that a building or land will be considered vacant if more than 80% (measured based on square footage of useable space) is unused. For new property, the Final Regulations retain the Proposed Regulations' standard that "original use" commences on the date on which the property is first placed into service in the QOZ for depreciation or amortization purposes.

Leased Property. Leased property is treated as qualifying under the QOZ rules so long as the lease is entered into after December 31, 2017 and the terms of the lease are market rate. The Final Regulations contain a rebuttable presumption that the terms of a lease are market rate if entered into between unrelated parties.

Intangible Assets. The Final Regulations provide additional guidance on whether intangible property is being "used" in a QOZ. This clarity is important because a QOZB must use a "substantial portion" (defined as 40%) of its intangible property in the active conduct of a trade or business in the QOZ. To qualify, intangible property must be "normal, usual, or customary" in the conduct of a trade or business and, furthermore, the intangible property must be used in the QOZ in the performance of an activity which contributes to the generation of gross income for such trade or business. These requirements provide needed clarification by ensuring that intangible assets are factored into the "substantially all" test and tying the "location" of the intangible assets to the actual location of a tangible activity using such assets. It is not clear whether an activity in which the intangible property is used must actually generate gross income to be considered as "contributing" to the underlying trade or business's income generation. If such activity must generate gross income to meet the "use" requirement, then the new rules would be disadvantageous to intangible asset-heavy start-up businesses that would not generate gross income for a substantial period of time due to a long research and development period, such as a biotech company developing a new drug.

Triple Net Leases. A QOZB must be engaged in the active conduct of a trade or business, which includes "the ownership and operation (including leasing) of real property." However, the Final Regulations reaffirm the Proposed Regulations' statement that "merely entering into a triple net lease with respect to real property owned by a taxpayer does not constitute the active conduct of a trade or business." The Final Regulations provide several examples defining a triple net lease and its qualification as an active trade or business, although the examples are not too revealing. Under the Final Regulations, a triple net lease is described as a lease arrangement pursuant to which the tenant is responsible for all of the costs relating to the leased property (e.g., paying all taxes, insurance, and maintenance expenses) in addition to paying rent. The examples underscore that meaningful participation in management or operations is the key factor in determining that an active leasing business exists for purposes of Section 1400Z-2. The Final Regulations contain less direct and specific guidance on this point than many commentators would have liked, and this standard will continue to be driven by the facts of each particular case and arrangement.

REIT Considerations. A taxpayer that receives a capital gain dividend from a REIT may choose to utilize the 180-day period that begins (1) on the last day of the shareholder's taxable year, or (2) on the day the capital gain dividend is paid. The latter alternative was provided in the Final Regulations in order to ensure that REIT shareholders do not have to wait until the close of their taxable year to invest capital gain dividends received during the taxable year, which was one of the timing concerns under the Proposed Regulations. It should be noted that the IRS declined to adopt certain rules that would have facilitated the realization of QOZ benefits by shareholders of REITs that themselves make qualifying investments in QOFs.

Foreign and Tax-Exempt Investors. The Final Regulations clarify that capital gains of nonresident alien individuals and foreign corporations may be deferred only if the gain is effectively connected with a U.S. trade or business.[8] Furthermore, gain may not be deferred if it is exempted from the federal income tax under an applicable treaty, unless the taxpayer irrevocably waives any treaty benefits that would otherwise exempt such gain. Similarly, for tax-exempt

U.S. investors, a deferral election will only be available with respect to an item of capital gain to the extent the item would be included in computing the organization's unrelated business taxable income under Section 511.[9]

Sin Businesses. While certain businesses are not eligible to be operated by a QOZB (such as country clubs, casinos and liquor stores), the Final Regulations expressly confirm that these restrictions are not applicable at the QOF level. Furthermore, a QOZB may not even lease more than 5% of its property to a sin business.

Effective Date. The Final Regulations will be effective 60 days after the publication in the Federal Register. Taxpayers may rely on either the Final Regulations or Proposed Regulations for taxable years beginning after December 21, 2017, and on and before the effective date of the Final Regulations, provided that the taxpayers apply the chosen rules consistently for all such taxable years. The estimated date is likely to be some time near the end of February 2020. The current operating agreements for QOFs or QOZBs may need to be amended and restated accordingly.

LOOKING FORWARD

The Final Regulations are an extremely important development for all stakeholders looking to apply and interpret the QOZ rules. It is clear that the rules are intended to promote flexibility while remaining true to the underlying policy of the statute. Many details of the Final Regulations will be better understood over time as market participants begin to apply and study them, and this summary only covers some of the most important questions. There are numerous other aspects of the rules pertaining to both real estate investments and operating QOZ businesses that are not addressed herein. We expect investment activity to pick up heading into 2020 and look forward to working with our clients in achieving their goals.

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[1] Unless otherwise indicated, all "Section" references herein are to the Code.
[2] T.D. 9889 (Dec. 19, 2019).
[3] However, the amount of qualified Section 1231 gains excludes applicable Section 1245 recapture gains and unrecaptured Section 1250 gains.

[4] That is, when deferred gains are included in income on December 31, 2026, or on an earlier trigger date, Section 1231(c) will recharacterize the deferred gains as ordinary to the extent of non-recaptured Section 1231 losses from the five most recent taxable years preceding the taxable year of inclusion.
[5] In the words of the Preamble, "[t]hese rules generally match the tax treatment that would exist for an owner of a QOF partnership or QOF S corporation after selling a qualifying investment in the QOF after it has been held at least 10 years, but would avoid the extra costs associated with negotiating the selling price of the interest in the QOF, rather than the underlying assets owned by the QOF or qualified opportunity zone business. The Treasury Department and the IRS project that this approach will lead to a reduction in transactions costs for taxpayers relative to alternative approaches."
[6] Section 1.1400Z2(b)-1(6)(iv)(D), T.D. 9889.
[7] The Final Regulations confirm that the safe harbor is unavailable at the QOF level.
[8] For example, gain from the sale of a U.S. real property interest that is treated as effectively connected income pursuant to Section 897.
[9] For example, gain that is treated as debt financed under Section 514.