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Qualified Opportunity Zone Funds

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IRS Publishes Final Opportunity Zone Regulations

On December 19, 2019, the Treasury Department and Internal Revenue Service (the "IRS") released final regulations for the opportunity zone ("OZ") program to refine and clarify certain aspects of the first two sets of proposed regulations (those issued on October 29, 2018 and those issued on May 1, 2019) and to make the rules easier to follow and understand (the "Final Regulations"). The IRS also released a frequently asked questions ("FAQ") document on the Final Regulations. The regulations provide taxpayers with necessary guidance for structuring investments and utilizing the OZ incentive program.

The OZ program was created as part of the Tax Cuts and Jobs Act (the "TCJA") signed into law on December 22, 2017, as a new tax incentive program to spur economic growth and investment in designated distressed communities (each an "opportunity zone" or "OZ"). The OZ incentive program allows for the deferral of certain capital gains to the extent such gain is invested in a qualified opportunity fund ("QOF"), but it also allows for income exclusion for gains on investments in QOFs that are held for at least 10 years.

This summary highlights certain major clarifications and additional flexibility found in the Final Regulations.

CHANGES RELATED TO ELIGIBLE GAINS

Deferral of Gross Section 1231 Gains: "Section 1231 assets" are unique assets for purpose of determining applicable tax treatment–basically a Section 1231 asset is depreciable property held in trade or business (***i.e.,*** business property), like a rental building or a piece of machinery.

The Final Regulations provide that investors (including pass-through entities) are allowed to invest the entire amount of "gross" 1231 gains from the sale of business property (without regard to 1231 losses) in QOFs. This enables more 1231 gains to be eligible for investment in QOFs because investors are no longer required to "net" their otherwise eligible Section 1231 gain against their Section 1231 losses. This change also provides investors more flexibility in realizing gains eligible to be invested in a QOF.

Investment Period Start Date: The 180-day period to invest Section 1231 gain into a QOF begins the date of the sale of the underlying asset. Investors do not have to wait until the end of the taxable year for the 180-day investment period to begin, eliminating the issue of unnecessarily delay or stalling of planned OZ investments. This is a great result for investors.

For example, if an investor has one million dollars of Section 1231 gain on January 7th and $500,000 of a Section 1231 loss in March, the deferral of that entire one million dollars of Section 1231 gain could be invested in a QOF and possible

income exclusion for gains on that investment in a QOF if held for at least 10 years. In addition, that $500,000 Section 1231 loss that would have otherwise offset capital gain is now going to be an ordinary loss, which is another favorable result for tax purposes.

As to the 180-day investment period for a pass-through entity (including, for example, a partnership), the Final Regulations provide three options for the investment period start date: (1) the date of the sale of the underlying asset; (2) the end of the taxable year; or (3) the due date of the entity's tax return, not including any extensions (which is currently March 15th for pass-through entities). Though the Final Regulations arguably leave open whether the gross Section 1231 gain rules and the 180-day investment period rules both apply to a partnership, a consistent application of the rules under the Final Regulations apply to "eligible gain" of an "eligible taxpayer," which would include gross Section 1231 gain of an eligible taxpayer that is a partnership, S corporation, trust, or decedent's estate.

Real Estate Investment Trust ("REIT"): REIT capital gains dividends are eligible to be excluded from income, so long as the investor has held their interest for 10 years. The 180-day period for REIT investors begins at the close of the investor's taxable year in which the capital gain dividend would otherwise be recognized, facilitating the ability of REIT investors to make qualifying investments in QOFs even when they do not have the same taxable year as the REIT.

CHANGES RELATED TO QUALIFIED OPPORTUNITY ZONE BUSINESS ("QOZB") PROPERTY

Working Capital Safe Harbor: The proposed regulations provided a 31-month working capital safe harbor for QOF investments in QOZBs that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in a QOZ (the "31-month working capital safe harbor").

To qualify for the safe harbor, the amount of working capital must be "reasonable," which means: (1) the amounts of working capital are designated in writing for the development of a trade or business in a qualified opportunity zone ("QOZ") , including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone (the "designated in writing" requirement); (2) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets and under such schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets (the "reasonable written schedule" requirement); and (3) the working capital assets are actually used in a manner that is substantially consistent with the writing and written schedule (the "property consumption consistent" requirement).

The 31-month working capital safe harbor exists because qualifying as an OZ investment is predicated on doing business inside of a QOZ, and doing business is ultimately measured by the assets held by the business in the OZ. However, in instances where the activities in the OZ consist of constructing assets or a start-up business, issues could arise in trying to convert the assets quickly from invested capital into, for example, "bricks and mortar" (***i.e.,*** hard assets).

Business assets cannot be QOZB property unless such assets are being used in a trade or business, have been placed in service, and for which the depreciation/ amortization period has begun. Start-up businesses, however, generally cannot deduct their expenses because they have to be capitalized—meaning during that start-up time, they are not treated as being engaged in a trade or business. In other words, if a start-up is not engaged in a trade or business, none of its assets can qualify as OZ business property and a QOF investment in such business would not qualify under the OZ program).

Taking this issue into consideration, the Final Regulations provide an expanded 62-month safe harbor—rather than a simple 31-month safe harbor, a QOZB can choose to apply a subsequent 31-month working capital safe harbor to tangible property for a maximum 62-month period. In determining whether the amount of working capital is "reasonable" under the requirements noted in this section above, any subsequent infusions of cash must be an integral part of the plan covered by the initial 31-month period and these later cash infusions must be properly and timely employed in accordance with such plan.

These changes are considered favorable because they expand the ability for assets to qualify as business property, even without an actual underlying operating business at that time.

Working Capital as Tangible Property: Note that though not certain under the Final Regulations, the preamble seems to make clear that working capital is treated as tangible property for purposes of applying the 70 percent tangible property standard. More precisely, the preamble makes clear that unexpended amounts of working capital are "not, following the conclusion of the final safe harbor period, tangible property for purposes of applying the 70 percent tangible property standard." Accordingly, working capital must be tangible property during the safe harbor period. The regulatory text itself is not clear on this point, but the preamble text seems to clarify that amounts held as working capital are "good assets," income earned on the working capital is treated as income derived from the active conduct of a trade or business, and any tangible property for which working capital is expended is treated as used in the trade of business and as QOZB property while covered by the safe harbor.

Intangible Property: The Final Regulations provide that intangible property is used in the active conduct of a trade or business in a QOZ if: (1) the use of the intangible property is normal, usual, or customary in the conduct of the trade or business; and (2) the intangible property is used in the QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business. This change in the Final Regulations addresses concerns surrounding valuation of intangible property used in the conduct of trade or business in OZs.

Cure Period: The Final Regulations also provide for a six-month cure period for a non-qualifying trade or business. If a trade or business causes the QOF to fail the 90 percent investment test on a semiannual testing date, the QOF may treat the stock or partnership interest in that business as QOZ property for that semiannual testing date provided the business corrects the failure within six months of the date on which the stock or partnership interest lost its qualification. This provides additional flexibility and takes into account practical difficulties businesses may encounter.

CHANGES RELATED TO SUBSTANTIAL IMPROVEMENT REQUIREMENT

Section 1400Z-2(d)(2)(D) requires that if tangible property was already used in a QOZ (non-original use asset) when purchased by a QOF or QOZB, then it needs to be substantially improved by the QOF or QOZB before it can become QOZB property.

Substantial improvement, as defined by section 1400Z-2(d)(2)(D)(ii), requires the QOF or QOZB to more than double the adjusted basis of the property within 30 months after acquiring the property.

Under the proposed regulations, the substantial improvement test was measured on an asset-by-asset basis, making it a practical impossibility to substantially improve (or quantify that substantial improvement) in some instances. The Final Regulations allow some flexibility, permitting investors to measure improvement in aggregate in certain circumstances—the following asset aggregation rules address the issue of how to measure substantial improvement.

Operating Assets: For purposes of determining whether basis has been doubled to meet the substantial improvement requirement for the non-original use assets, the cost of purchased property that qualifies as QOZB property (***i.e.,*** original use property) may be added to the basis of purchased non-original use assets if the original use assets in the same zone (or a contiguous zone) are used in the same trade or business and improve the functionality of non-original use assets being improved (the "functionality" test).

For example, a developer would just need to show how its purchase of furniture and equipment adds to the functioning of the old property they bought to develop. It remains unclear, however, how this rule would apply outside of the real estate context (***e.g.,*** how it would apply to a fund that invest in a business with an assembly line, and buys a new assembly line).

Buildings: For clusters of commonly-owned buildings, buildings that are part of an "eligible building group" can be aggregated for purposes of applying the substantial improvement requirement.

Buildings on a single deeded property may be treated as a single property and buildings on contiguous parcels of land may be treated as a single property as long as they are: operated exclusively by the QOF or QOZB; share business resource elements (***e.g.,*** accounting or other back office functions) or employees; and are operated in coordination with one or more of the trades or businesses (***e.g.,*** supply chain interdependencies or mixed-use facilities). For two or more buildings treated as a single property, the amount of basis required to be added will be the total basis of each building.

Ambiguity remains for demolished property because Treasury did not affirmatively clarify that structures in an OZ that will be demolished pursuant to the development of a trade or business should be treated as QOZB property during the period before demolition.

Vacant Property: Property in an OZ will qualify as QOZB original use property (meaning it does not need to be substantially improved) if it was vacant one year before the designation of the tract as an OZ (three years for other property). Regarding the definition of vacant, real property, including land and buildings, is considered vacant if the property is "significantly unused," meaning more than 80 percent of the building or land, as measured by the square footage of useable space, is not being used. This could boost the number of viable real estate projects qualifying under the OZ program, especially in areas overwhelmed with abandoned lots.

Land: The Final Regulations retain the rule that land is not required to be substantially improved. However, the regulations also retain the rule that land should be improved by more than an insubstantial amount, which is a fact intensive inquiry.

When applying the "functionality" aggregation rule to non-original use land, the original use property must improve the land by a more than insubstantial amount. Improvements to the land, including grading, clearing of the land, remediation of contaminated land, or acquisition of related QOZB property that facilitates the use of the land in a trade or business of the eligible entity, will be taken into account in determining whether the land was improved by more than an insubstantial amount.

The Final Regulations include both a square footage test and an unadjusted cost test to determine if a project is primarily in a QOZ, and provide that parcels or tracts of land will be considered contiguous if they possess common boundaries, and would be contiguous but for the interposition of a road, street, railroad, stream, or similar property. Importantly, the Final Regulations also extend the straddle rules to QOF's and QOZB's with respect to the 70 percent use test.

Note that with respect to brownfields, the Final Regulations provide that all property that is part of a brownfield site (including land and structures) is considered original use property (***i.e.,*** no substantial improvement requirement) as long as, within a reasonable period of time, investments are made to ensure that the property meets basic safety standards for both human health and the environment. In addition, brownfield remediation will be considered "more than insubstantial" improvement of land.

Nonqualifying OZ Property: The Final Regulations clarify that improvements made to nonqualifying OZ property (either because it was purchased on or before December 31, 2017, purchased from a related party, or lacks substantial improvements) do not satisfy original use requirements as purchased property, unlike lessee improvements to leased property, which are treated as separate property and satisfy the original use requirement as purchased property for the amount of the unadjusted cost basis of such improvements.

The Final Regulations clearly provide that self-constructed property (property manufactured, built or produced by a taxpayer for its trade or business) is generally eligible to be considered "acquired by purchase" (so not subject to the substantial improvement test).

QOF Tangible Property: The Final Regulations made changes related to tangible property, which affect various aspects of the OZ program.

Tangible property used in a trade or business of an eligible entity satisfies the substantially all requirement of the 70 percent use test if it is qualified tangible property and the Final Regulations provide that tangible personal property can be included for purposes of meeting the substantially improved test.

In addition, the Final Regulations resolved the issue of whether inventory should be excluded from the 70 percent test for QOZBs by providing taxpayers the option to exclude inventory (including raw materials) from the numerator and denominator of the 70 percent use of tangible property test and the 90 percent investment standard test for QOF direct investments in QOZB property.

Related Party Fees: The Final Regulations did not clarify that reasonable capitalized fees paid to a related party with respect to the development or redevelopment of tangible property are considered an addition to adjusted basis for purposes of measuring the substantial improvement of property and do not cause the property to fail to qualify as QOZB property.

Substantial Improvement Period: The Final Regulations clarify that for both QOFs and QOZBs, property in the process of being improved is treated as used in a trade or business and satisfies the requirements of the 31-month substantial improvement test (***i.e.,*** the QOF or QOZB does

not need to wait until the improvements are completed to treat the property as substantially improved for purposes of the 90 percent or 70 percent tests).

To address concerns that the 31-month working capital safe harbor for substantial improvements would be violated by delays caused by projects disrupted by events beyond taxpayers' control, the Final Regulations provide QOZBs located in federally declared disaster areas an additional 24-month period to use working capital after the initial 31-month safe harbor period. This is an expansion of the relief provided by the proposed regulations for delays attributable to waiting periods for government actions (***e.g.,*** projects requiring extensive permitting and other types of governmental approvals), which is a toll on the 31-month safe harbor period for a duration equal to the permitting delay.

CHANGES RELATED TO TYPE OF ENTITY

Corporate Consolidated Return Rules: Corporations with one or more subsidiaries are generally treated as a consolidated group and generally file a consolidated return. Treasury provided certain rules in the Final Regulations, which are considered favorable changes.

First, the Final Regulations provide that a QOF is also allowed to be a member of a consolidated group, subject to certain conditions. In addition, the Final Regulations allow a member of a consolidated group to make investments in a QOF of the capital gains of another member of the consolidated group.

These changes should be considered in the context of large companies as well as banks, which tend to form community development arms for the sort of investments made in OZs: the Final Regulations allow a member of a consolidated group different from the member of the group that recognized the gain to invest the gain (***e.g.,*** gain recognized from sale of capital asset by one part of a bank and another division of the bank (like the community investment part of such bank) could make the investment.

10-Year Sale of Interest in a QOF Partnership: When a partner sells a QOF interest after 10 years and elects to adjust the basis of their partnership interest to fair market value ("FMV"), the QOF partnership may adjust partnership assets to the net FMV of the disposed-of interest, plus the partner's share of partnership debt. This clarification is intended to prevent a reduction in an investor's share of partnership debt upon selling a QOF partnership interest from reducing the QOZ tax benefits provided by the 10-year basis step-up.

10-Year Gain Exclusion Provision for Partnerships and S Corporations: Gain exclusion for asset sales by QOFs and QOZBs was expanded in the Final Regulations. When a QOF partnership or S corporation sells property, if its owners have held their interest for 10 years, such owners can make an election for each taxable year to exclude a QOF's gains from all sales or exchanges in the taxable year (not just capital gains). This exclusion rule extends to pass-through gains from the sale of property by QOZBs owned by a QOF, but does not apply to gains from the sale of inventory by the QOF in the ordinary course of business.

Note that the Final Regulations did not address the "interim gain problem;" investors have to hold qualifying investment for 10 years for gain exclusion.

Special Gain Inclusion Rule: Unfortunately, Treasury did not change the special gain inclusion rule that can result in investors in QOF partnerships having to recapture some or all of prior losses, as capital gain income, on December 31, 2026.

The statute generally provides that a QOF investor's deferred gain is not subject to tax until the earlier of: (1) the date the investor sells or exchanges the qualifying investment; or (2) December 31, 2026.

Deferred gain becomes taxable to the extent a transaction reduces the taxpayer's equity interest in the qualifying investment. The regulations provide an extensive list of such transactions, including sales of the taxpayer's interest in the QOF, sales of an interest in an S corporation or partnership that is a QOF investor, and gifts of the QOF interest.

Provided that distributions from QOF partnerships and S corporations do not exceed the partner's or shareholder's basis, there is no inclusion event. Similarly, dividend distributions from C corporations are not an inclusion event, unless the dividends are in excess of basis.

When there is an inclusion of the deferred gain, the proposed regulations (which were not changed under the Final Regulations) require the QOF investor to include the lesser of two amounts in income, minus the investor's basis. The first is the FMV of the investment disposed of, and the second amount equals "an amount which bears the same

proportion to the remaining deferred gain as" the first amount bears to the "FMV of the total qualifying investment immediately before the inclusion event." In other words, there is no change under the Final Regulations to the requirement that partnerships and S corporations basically have to recapture their losses at a minimum on an inclusion event.

Carried Interest: The carried interest rules are generally retained but the Final Regulations change how the allocation percentage is calculated. The proposed regulations provided that carried interests (***i.e.,*** profits interests in a partnership that are received in exchange for services) must be treated as nonqualifying investments under the QOZ rules and included rules for determining the "allocation percentage" of a partner's qualifying and nonqualifying interests when a partner made a qualifying capital investment and also received a nonqualifying carried interest.

The Final Regulations provides that the portion of sales proceeds allocated to the nonqualifying carried interest for the percentage is now based on the share of residual profits the mixed-funds partner would receive with respect to the carried interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application, and is no longer based on the highest share of residual profits the partner would receive with respect to the carried interest.

CHANGES RELATED TO BASIS ADJUSTMENTS

Effect of Inclusion Event on 10-Year FMV Basis Election: The Final Regulations include a number of modifications and clarifications to the rules relating to "inclusion events" (***i.e.,*** events that result in an investor recognizing all or a part of their deferred gain).

An inclusion event generally results in a reduction or termination of a qualifying investment's status as a qualifying investment to the extent of the reduction or termination. However, certain types of inclusion events (namely, certain distributions) do not terminate an investor's qualifying investment and do not preclude a subsequent 10-year basis step-up, as long as the investor continues to own the QOF interests. Note that a debt-financed distribution of cash to a QOF partnership investor is generally not an inclusion event if made after two years.

Option to Disregard Recently Contributed Property to a QOF: The Final Regulations generally retain the rules under the proposed regulations permitting a QOF to disregard recently contributed property for purposes of the 90 percent investment test, expressly rejecting any change to avoid an undefined mathematical result if all of the QOF's property were being disregarded under this rule. The Final Regulations provide that a QOF has until the fifth business day after a contribution of property to exchange such property into cash, cash equivalents, or short-term debt in order to qualify for the rules. Treasury and the IRS declined to adopt recommendations to expand this rule from six months to 12 months, at least during a QOF's initial start-up period, and also declined to adopt recommendations to provide a wind-down period safe harbor for applying the 90 percent investment test.

Transfer of Qualifying Interest by Reason of Death: The Final Regulations clarify that Code Section 1014 does not apply to adjust (or "step-up") the basis of an inherited qualifying OZ investment (***i.e.,*** interest in a QOF) to its FMV as of the deceased owner's death.

This clarification in the Final Regulations came as a surprise; many commentators hoped that the Final Regulations would provide for a step-up in basis of the qualifying interest to its FMV at the date of the decedent's death (which would reduce the beneficiary's capital gains tax on inherited qualifying OZ property in a manner consistent with how the Code treats other inherited property), and instead the Final Regulations confirm that the basis remains at zero with respect to the QOF investment. This rule will complicate estate planning for QOF investors.

CHANGES RELATED TO PROPERTY THAT A QOF LEASES

Leased Property: The Final Regulations limit the requirement of proof of arm's length leasing arrangement to related parties and create a rebuttable presumption that the terms of a lease are market rate for leases between unrelated persons.

The Final Regulations also provide that the requirement for property leases to be arms-length does not apply to leases with a state or local government, or an Indian tribal government.

Lastly, the Final Regulations provide that short-term leases of personal property to lessors using the property outside a QOZ may be counted QOZB property.

Sin Businesses: The Final Regulations provide that a business that leases more than a ***de minimis*** amount of property to a sin business is not a QOZB and this ***de minimis*** threshold was set at five percent. In other words, a QOZB cannot lease more than five percent of its real property to a sin business. The Final Regulations also provide clarification that the prohibition on sin businesses only applies to a QOZB; this prohibition does not apply to a QOF. To serve as an example, the FAQs provide that a hotel business of a QOZB could potentially lease space to a spa that provides tanning services.

As a reminder, a "sin business" includes any (i) private or commercial golf course, (ii) country club, (iii) massage parlor, (iv) hot tub facility, (v) suntan facility, (vi) racetrack or other facility used for gambling, or (vii) store the principal business of which is the sale of alcoholic beverages for consumption off premises.

CONCLUSION

The issuance of the Final Regulations is an important step in the ongoing process of providing guidance to enable taxpayers to structure investments and otherwise utilize the OZ incentive program. Clients should reach out to Blank Rome's Qualified Opportunity Zone Funds group with any questions.

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