CLIENT ALERT

There's No Place Like O-Zone: Final Opportunity Zone Regulations Provide Clarity, Flexibility

January 29, 2020

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Just as Dorothy's house crushed the Wicked Witch of the East in *The Wizard of Oz*, the 544-page final regulations package, released on December 19, 2019 (and published in the Federal Register on January 13, 2020), has dispelled much of the uncertainty surrounding the opportunity zone ("OZ") rules in section 1400Z-2.[1] These rules, enacted as part of the Tax Cuts and Jobs Act, are designed to encourage investments in low-income communities designated as qualified opportunity zones ("QOZs"). The final regulations generally clarify and expand on two sets of proposed regulations, released in October 2018 and April 2019.[2]

In general, the OZ rules allow taxpayers to defer certain gains until the end of 2026 by investing in equity interests of a qualified opportunity fund ("QOF"), reduce the deferred gain by up to 15% by meeting certain holding period requirements, and permanently exclude any new gain on a QOF investment held for at least 10 years.

Structure and Exit

Based on the statutory language, QOFs were initially structured based on the understanding that an investor could only exclude gain after 10 years in connection with the sale of its QOF interests. The final regulations expand provisions in the proposed regulations to permit favorable exit strategies in connection with certain direct or indirect asset sales by QOFs. This should encourage the formation (or restructuring) of QOFs as single QOF funds holding multiple properties, rather

1 Section references are to the Internal Revenue Code of 1986, as amended.

2 Please see our earlier client alerts addressing (i) the statutory OZ rules here, (ii) the October 2018 proposed regulations here, and (iii) the April 2019 proposed regulations here.

than as collections of single-asset QOFs, the interests in which could be sold separately. (The latter approach, however, would allow investors to elect to eliminate gains on some QOFs while retaining losses from others, even if the gains and losses arise in the same year.)

The final regulations permit investors that have held their qualifying QOF interests for at least 10 years to exclude gain from a sale of assets by the QOF or by a flow-through qualified opportunity zone business ("QOZB") in which the QOF invests. In addition, the final regulations make clear that, with a QOF partnership, an asset sale will not produce taxable gain from relief of fund-level (or QOZB-level) liabilities or ordinary income as a result of depreciation recapture. For an asset sale by a QOF partnership, the only exception to the exclusion is for gain from the sale of inventory in the ordinary course of business.

If a QOF partnership distributes the net proceeds from an asset sale within 90 days, the investor will not lose the ability to exclude gains from any future asset sale. To the extent the QOF does not make such a distribution within 90 days, a portion of the investor's interest will become a non-qualifying interest (generally in proportion to the investor's share of the sales proceeds as compared to the total value of her interest), which can distort the amount of gain from future asset sales that can be excluded. It is possible that similar distortive effects could result in connection with undistributed capital gains of a QOF that is a regulated investment company ("RIC") or real estate investment trust ("REIT").

For example, assume Dorothy invests $150 in a QOF partnership that purchases three parcels of land of equal value. After 10 years, when the value of each parcel has doubled, the QOF sells one parcel and allocates $50 of gain to Dorothy, which she elects to exclude from income under the OZ rules. If the QOF retains the sales proceeds, Dorothy will be treated as holding a non-qualifying interest worth $100 (her share of the retained proceeds) and a qualifying interest worth $200 (representing the remainder of her investment). The QOF sells the second parcel of land the next year, when further appreciation has caused Dorothy's share of the gain on that parcel to increase from $50 to $65. Because the first $50 of gain was "built-in" when her interest was divided, this amount should be allocated to Dorothy only with respect to her qualifying interest, so that she should be able to exclude this $50 of gain. However, it appears that the next $15 of gain would be allocated $10 to her qualifying interest and $5 to her non-qualifying interest (based on the relative values of the interests). If the QOF had distributed the gain from the first asset sale within 90 days, her interest would not have been divided and she would have been able to exclude all of the gain from the second asset sale.

A QOF that is treated as a RIC or REIT and that recognizes long-term capital gain from the sale of qualifying assets may distribute net capital gain identified with such asset sales as specially designated capital gain dividends, which a shareholder who has held its shares for at least 10 years can elect to exclude from taxable income. Note that shareholders of QOF RICs and REITs can only exclude capital gains from the QOF's sale of qualifying assets, whereas investors in a QOF partnership can exclude gains from any asset sale (other than from sales of inventory in the ordinary course of business). Under the proposed regulations, the specially designated RIC or REIT capital gain dividend would have been subject to a zero rate of tax. The income exclusion formulation in the final regulations should reduce the likelihood that state income taxes would apply to such a dividend, at least in states that calculate their taxes by reference to federal adjusted gross income.

Investor Issues

To qualify for OZ tax benefits, a taxpayer generally must invest eligible gains in equity interests of a QOF during the 180-day period following the date on which the gain is realized. The final regulations provide greater flexibility and clarity than the proposed regulations in relation to this requirement.

- *Gross section 1231 gain*. In general, section 1231 treats gains and losses from sales of property used in a trade or business as long-term capital gain if gains from such sales in a given taxable year exceed losses from such sales in that taxable year, and as ordinary loss if such losses exceed such gains. The final regulations permit an investor to defer gross section 1231 gains, with the 180-day investment period generally tied to the date of the sale, even if section 1231 losses in the same year would otherwise have eliminated those gains. The proposed regulations had required investors to wait until the end of the year, after sections 1231 gains and losses could be netted, to begin the applicable 180-day investment period, at which time deferral was only permissible in respect of net section 1231 gains for the taxable year.

- *Installment sales*. If a taxpayer realizes capital gain under an installment sale and receives multiple payments during the year, the taxpayer can elect to tie the 180-day investment period to the date on which each installment payment is received or the last day of the taxable year. The final regulations also confirm that gain associated with an installment payment received after December 31, 2017 can be eligible for deferral under the OZ rules even if the sale occurred before that date.

- *Partnerships and other pass-through entities*. The final regulations provide flexibility in dealing with gains realized through a pass-through entity, provided that the pass-through entity itself does not elect to defer these gains under the OZ rules. In general, the 180-day period begins on the last day of the partnership's tax year in which the partner's distributive share of the partnership's eligible gain is taken into account. For example, a partner in a calendar-year partnership with 2019 eligible gains can invest an amount corresponding to his allocable share of the gains in a QOF during the 180-day period beginning on December 31, 2019. A taxpayer may elect, however, to use the 180-day period beginning on (i) the date on which the partnership realized the particular eligible gains, or (ii) the due date for the partnership's tax return, without extensions (*e.g.*, March 15, 2020 for a calendar-year partnership with 2019 eligible gains). Similar rules apply to a taxpayer's share of eligible gains from a trust, estate or S corporation.

- *RIC and REIT capital gain dividends*. The 180-day period for investing RIC or REIT capital gain dividends generally begins at the close of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized by the shareholder. A taxpayer may elect to begin the 180-day period on the date that the capital gain dividend is paid, but could then face the risk of investing ineligible gain if the RIC or REIT ultimately cannot designate that dividend as a capital gain dividend. For undistributed capital gains, the 180-day period begins on either the last day of the shareholder’s taxable year in which the dividend would otherwise be recognized or the last day of the RIC or REIT’s taxable year, at the shareholder’s election.

- *In-kind contributions*. The final regulations confirm earlier guidance that qualifying assets for a QOF do not include property contributed in a tax-free exchange. The preamble to the final regulations adds that an investor generally cannot avoid this result by selling property to a QOF and then contributing the cash consideration received in the sale to the QOF; the payment of the purchase price and the cash contribution would likely be ignored as a circular cash flow, causing these transactions to be recast as an in-kind contribution.

- *Disguised sales*. The final regulations retain the rules from the proposed regulations that reduce the amount of a taxpayer’s qualifying investment if the taxpayer’s contribution of cash or property is tied too closely to a partnership distribution, as determined under rules for disguised sales (with certain modifications). The final regulations make clear, however, that the exceptions in the disguised sale rules apply for this purpose. For example, distributions of operating cash flow will not result in a disguised sale.

- *Offsetting positions*. A rule in the proposed regulations prohibiting the investment of gains from an offsetting positions transaction has been narrowed in the final regulations to apply only to gain that is part of a straddle. Specifically, the final regulations provide that eligible gain does not include gain from a position that was part of a straddle during the taxable year, or was part of a straddle in a prior year if loss from any position in that straddle is treated as sustained in the taxable year.

- *Carried interest*. An interest in a QOF partnership issued in exchange for services (*i.e.*, a carried interest) does not qualify for OZ benefits. If the partner also contributes amounts corresponding to eligible gains, the partner would (solely for purposes of the OZ rules) be treated as holding two separate partnership interests, only one of which would qualify for tax benefits. The final regulations provide that the allocation percentage of the non-qualifying interest is determined based on the share of residual profits the partner would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application. This formulation seems designed to prevent the use of remote residual allocations to allocate less to the carried interest partner’s non-qualifying interest and more to its qualifying interest.

- *Inclusion events*. The occurrence of an “inclusion event” causes an investor to recognize gains deferred under the OZ rules and, in certain cases, to forfeit any further OZ tax benefits with respect to all or a portion of the qualifying investment. In general, inclusion events are transactions that reduce or terminate the investor’s direct or indirect qualifying investment or (in the case of distributions) constitute “cashing out” of the investor’s qualifying investment. For example, a distribution by a QOF partnership generally will be treated as an inclusion event to the extent it exceeds an investor's basis in the qualifying QOF interest. Similarly, transfers by gift (other than gifts between a grantor and its grantor trust) and transfers between spouses incident to divorce will be treated as inclusion events.

The final regulations did not adopt a request for a general rule excluding partnership divisions from treatment as inclusions events.

The final regulations, like the proposed regulations, generally treat dividend-equivalent redemptions by QOF C corporations as inclusion events with respect to the full amount of the distribution, because the redemption reduces the investor's interest in the QOF even if it is treated as a dividend for tax purposes. The following transactions, however, are generally not inclusion events: redemptions by wholly-owned QOF C corporations, unless the distribution results in shareholder-level gain (because it exceeds the corporation's earnings and profits and the shareholder's basis); and pro-rata redemptions by a QOF C corporation with only one class of stock outstanding.

- *Transfers at death*. The final regulations confirm that a direct transfer, or an estate or testamentary trust distribution, of a qualifying QOF interest by reason of death generally will not constitute an inclusion event. The recipient of the qualifying QOF interest essentially steps into the shoes of the decedent with respect to the interest (inheriting the basis and other characteristics of the qualifying QOF interest). In contrast, any portion of a decedent's investment in a QOF that constitutes a non-qualifying interest in that QOF would be subject to the regular basis step-up rules of section 1014.
- *Rollover of gain from inclusion event*. The final regulations clarify that a taxpayer that realizes capital gain from an inclusion event (whether from a complete or partial disposition of the interest in the QOF) can potentially defer the gain from the inclusion event by subsequently investing the amount of such gain into a QOF (provided all other requirements under the OZ rules are met in relation to the new QOF investment). This is an expansion of the proposed regulations, which would have only permitted further deferral of inclusion event gain if the taxpayer had disposed of its entire investment in the QOF. It is not entirely clear whether inclusion event gain from a partial disposition (as opposed to a complete disposition) of an interest in a QOF can be deferred by means of an investment in that same QOF or whether the investment must be made in a different QOF.

QOF and QOZB Qualification

A QOF must hold at least 90% of its assets directly in QOZ business property or in shares in a corporation or interests in a partnership that is a QOZB, based on the average percentage of its qualifying assets on the last day of the first six-month period and on the last day of each taxable year of the QOF (the "90% test"). QOZ business property is tangible property used in a trade or business by a QOF that is acquired by purchase from an unrelated party after 2017, has its original use in the QOZ commencing with the QOF or is substantially improved by the QOF, and substantially all of its use during substantially all of the QOF's holding period was in a QOZ.

The OZ rules tend to favor indirect investments by QOFs through underlying corporations and partnerships, rather than direct investments in QOZ business property. The final regulations provide helpful rules for both types of investment and additional clarity for investments in operating businesses.

- *Safe harbor for 90% test during 30-month substantial improvement period*. A QOF or QOZB must purchase tangible property that it originally uses in a trade or business in the QOZ (and that, subject to certain exceptions, has not been previously used in the QOZ) or that it substantially improves, by doubling its basis in the property, during the 30 months following acquisition. The final regulations provide that during the 30-month substantial improvement period, eligible tangible property in the process of being improved but not yet placed into service or used in the trade or business of the QOF or QOZB is generally treated as satisfying the original use requirement and substantial improvement requirement. (As discussed below, a QOZB can also rely on an up to 62-month working capital safe harbor for such improvements.)

- *Asset aggregation to determine substantial improvement*. The final regulations provide an asset aggregation rule that should help operating businesses. In determining whether property is substantially improved (that is, that the investment in the property has doubled), a QOF or QOZB can take into account newly purchased assets (that would otherwise constitute original use property) that are used in the same trade or business as the property that is being substantially improved, improve the property's functionality, and are located in the same QOZ or a contiguous QOZ as the property being improved. These newly purchased assets are essentially treated as part of the substantial improvement of the property, and are not evaluated separately as original use property. The final regulations provide an example in which a QOF includes purchases of mattresses, linens, furniture, electronic equipment, and other tangible property in the basis of a hotel to meet the substantial improvement requirement in respect of the hotel. Additionally, the final regulations provide circumstances in which buildings located on the same parcel of land or within contiguous parcels of land may be aggregated, and essentially treated as if they were a single property, for purposes of the substantial improvement test.

- *Consolidated groups*. The proposed regulations had balked at allowing a QOF C corporation to be a member of a consolidated group because of the complexity involved. In response to comments, the final regulations permit this, so long as the member that invests in the QOF maintains its direct equity investment. The investor member also must take into account any excess loss account – essentially, negative basis – with respect to the QOF before any basis adjustment under the OZ rules.

- *62-month working capital safe harbor*. The final regulations expand a working capital safe harbor to allow a business up to 62 months to qualify as a QOZB. Note that this safe harbor is available only to QOZBs – subsidiary partnerships or corporations in which a QOF invests – and not to the QOF itself.

  Generally speaking, a QOZB is a trade or business that meets the following requirements: (i) at least 70% of the tangible property owned or leased by the entity is QOZ business property as described above, (ii) at least 50% of the entity’s gross income is derived from the active conduct of a business in the QOZ, (iii) at least 40% of its intangible property is used in the active conduct of any such business, (iv) less than 5% of its assets consist of nonqualified financial property (such as stocks, options, etc.), and (v) the entity does not operate a “sin business,” as discussed below.

  Under a working capital safe harbor, a QOZB is treated as satisfying these requirements (other than the prohibition on sin business investments) during a 31-month safe harbor period if it holds a reasonable amount (as determined under the final regulations) of working capital assets – cash, cash equivalents, or debt instruments with a term of 18 months or less – for the purpose of investing in qualifying assets. The final regulations confirm that a QOZB may string together subsequent or overlapping working capital safe harbor periods with respect to the same tangible property for a maximum 62-month period, so long as each 31-month period independently satisfies the safe harbor requirements and the plan for the initial 31-month period contemplated later infusions of working capital.

  The 31-month period can also be extended for up to 24 months if the project covered by the working capital safe harbor is located in a federally declared disaster area. Further, a QOZB will not be treated as having failed to expend its working capital assets within an applicable 31-month safe harbor period if the expenditure of the assets was delayed by waiting for governmental action the application for which was complete within the 31-month period.

- *Triple-net lease*. The proposed regulations provided that merely entering into a triple-net lease with respect to real property owned by a taxpayer does not constitute an active conduct of a trade or business under the QOZB requirements. The final regulations add an example showing that entering into a triple-net lease in addition to other activities, such as leases that are not triple-net leases and in which the employees of the lessor meaningfully participate, can constitute an active trade or business.

- *Sin businesses*. A QOZB may not be engaged in a “sin business”: a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or a store the principal business of which is the sale of alcoholic beverages for consumption off-premises. The final regulations, however, provide that the receipt of a *de minimis* amount of gross income from a sin business will not cause an otherwise qualifying trade or business to fail to qualify as a QOZB. The final regulations, however, strengthen the prohibition on QOZB sin businesses by prohibiting a QOZB from leasing more than 5% of its property to a sin business, even though the statute does not explicitly address the leasing of assets by a QOZB to a sin business. Note that the restriction on sin businesses applies only to QOZBs, and not to direct QOF investments in QOZ business property.

- *Six-month cure period*. A QOF’s satisfaction of the 90% test depends on the qualification of each of its subsidiaries as a QOZB. The final regulations provide a six-month cure period during which a QOF is treated as satisfying the 90% test while a subsidiary cures a failure to qualify as a QOZB. A QOF can utilize the cure period only once and the use of the cure period may require a QOF to extend the time for filing its tax return (and require the QOF to file its return no later than when the cure is achieved). If the defect is not corrected after six months, the QOF can be subject to penalties for failure to meet the 90% test as if the six-month cure period had not applied, subject to its ability to avoid the penalty by showing reasonable cause.

Anti-Abuse Rule

The proposed regulations provided a general anti-abuse rule, which requires the OZ rules to be applied in a manner consistent with the purposes of section 1400Z-2 and permits the IRS to recast a transaction if a significant purpose of the transaction is to achieve a tax result that is inconsistent with these purposes. To assist in applying this anti-abuse rule, the final regulations articulate the purposes of the OZ rules: to provide specified tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and QOZBs, of new capital in one or more QOZs, and to increase the economic growth of such QOZs. The final regulations also provide examples for the anti-abuse rule. One particular concern reflected in the examples is with speculative investments in land (referred to in the proposed regulations as “land banking”). The issue is whether the taxpayer’s post-acquisition investment shows that land is being used to develop an operating business in the QOZ (which would not run afoul of the anti-abuse rule), rather than merely being held with a minimum level of activity to inappropriately reap the benefit of the OZ rules in relation to appreciation on what is essentially bare land. The final regulations also include a special partnership anti-abuse rule intended to curb the use of partnerships to invest partnership-level gains in QOFs where a significant purpose of the use of the partnership was to avoid the requirement that a QOF investment be made using gains that would otherwise be subject to tax absent the application of the OZ rules.

Effective Date

The final regulations are generally effective for taxable years beginning after March 13, 2020. For earlier periods, a taxpayer may choose to apply the final regulations or the applicable proposed regulations, but in either case only if applied in their entirety and in a consistent manner for all such taxable years.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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