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Practice Update

Treasury and IRS Issue Final Opportunity Zone Tax Regulations

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On December 19, 2019, the Treasury and the IRS fulfilled their promise to issue final regulations by year-end that provide guidance on Qualified Opportunity Zone (QOZ) investments.[1] These regulations (the Final Regulations), which supersede and revise the prior two sets of proposed regulations issued on October 19, 2018 and on April 1, 2019 (collectively, the Proposed Regulations),[2] are for the most part quite taxpayer-friendly and provide much-needed clarity and certainty in the interpretation of the statute.[3]

Background

As noted in the prior two Akerman Practice Updates that analyzed the Proposed Regulations shortly after the respective issuance of each,[4] Code Sec. 1400Z-2, which was enacted with the Tax Cuts and Jobs Act, P.L. 115-97 (December 22, 2017), confers three Federal income tax benefits on taxpayers that make longer-term investments of new capital in one or more designated QOZs through qualified opportunity funds (QOFs) that is turn invest in QOZ businesses (QOZBs) or QOZ business property (QOZBP) (either such investment a "qualifying investment"). The first tax benefit is the ability of a taxpayer, upon the making of a valid election and a timely investment of such gain within a 180-day period, to defer until as late as December 31, 2026, the inclusion in gross income of certain gains

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taxable as capital gains that would otherwise be recognized within a taxpayer's tax year.[5]

The second benefit is that such taxpayer may potentially exclude 10 percent of such deferred gain from gross income if the eligible taxpayer holds the qualifying investment in the QOF for at least 5 years.[6] An additional 5 percent of such gain may also be excluded from gross income if the taxpayer holds that qualifying investment for at least 7 years and had made the qualifying investment no later than December 31, 2019.[7] However, Code Sec. 1400Z-2(b)(1) provides that all gain to which a deferral applies must be included in income in the tax year that includes the earlier of the date on which a QOF investment is sold or exchanged (an "inclusion event") or December 31, 2026.

Finally, the third benefit of a qualifying investment is the ability of the taxpayer, upon the making of a separate valid election, to exclude from gross income any appreciation on the taxpayer's qualifying investment in the QOF if the eligible taxpayer holds the qualifying investment for at least 10 years.[8]

A brief summary of the QOZ program is necessary to understand the impact of the Final Regulations. A QOF is any investment vehicle that is organized as a corporation or a partnership to invest in QOZ property (other than another QOF) and that holds at least 90 percent of its assets in QOZ property.[9] Generally, QOZ property is QOZ stock, a QOZ partnership interest, or QOZBP.[10] A QOZB is, in general, a trade or business in which substantially all (i.e., at least 70 percent) of the tangible property owned or leased by the taxpayer is QOZBP.[11] QOZBP is tangible property used in a trade or business of the QOF if the following conditions have all been met:

1. The property is acquired by purchase (as defined in Code Sec. 179(d)(2)) by the QOF after 2017 or leased after 2017 by the QOF;[12]

2. If acquired by purchase, the seller is a person that is not a related person (within the meaning of Code Sec. 1400Z-2(e)(2));[13]
3. The original use of the property in the QOZ starts with the QOF (or the QOF substantially improves the property);[14] and
4. During substantially all of the QOF's holding period in the property (i.e., at least 90 percent), substantially all of the use of the property (i.e., at least 70 percent) is in the QOZ;[15] and

For a business to qualify as a QOZB, a substantial portion (i.e., at least 40 percent) of the intangible property of such entity must be used in the active conduct of the trade or business in the QOZ, and the business must derive at least 50 percent of its total gross income from the active conduct of a trade or business within a QOZ.[16]

Also, less than 5 percent of the property of a QOZB can be attributable to nonqualified financial property (as defined in Code Sec. 1397C(e)(7)), a term which includes cash.[17] However, a working capital safe harbor is available for cash held by businesses, which cash (together with other nonqualified financial property) constitute 5 percent or more of a QOZB's nonqualified financial property, if the business utilizes such cash to develop a new business or acquires, constructs or rehabilitates tangible business property (including real property) used in a business operating as a QOZB.[18]

By statute, certain "sin" businesses cannot be a QOZB (although there is no prohibition on a QOF directly conducting a sin business). These businesses are private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetrack or other facilities used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.[19] As discussed below, the

Final Regulations also provide the circumstances under which a QOF may derive a limited amount of income from a sin business.

The Final Regulations

The Final Regulations, comprised of a lengthy explanatory preamble followed by the actual regulations themselves, are a weighty 554-page package that merges and extensively revises both sets of Proposed Regulations into a coherent package. The revisions of the Proposed Regulations consist in good measure of the adoption by the Treasury and IRS of suggestions and comments submitted by taxpayers, as well as the tax sections of various bar associations (including the ABA and the NYSBA). The upshot is that the Final Regulations provide, in highly taxpayer-friendly fashion, a great deal more flexibility than appeared in the Proposed Regulations in terms of the types of gain that can be contributed to a QOF and the timing of such contributions; the types of gains subject to the 10-year gain elimination benefit; an expansion of the working capital safe harbor rules; and a liberalization of several other key definitions and operating rules, as further described below.

Clarification Within the Final Regulations of the Types of Gains that May be Invested and the Timing of Investments

Sales of business property ("Sec. 1231 gains" and "Sec. 1231 losses")

The Proposed Regulations only permitted the amount of an investor's Sec. 1231 gains from the sale of business property that were greater than the investor's Sec. 1231 losses from such sales to be invested in QOFs, and required the 180-day investment period to begin on the last day of the investor's tax year. The Final Regulations allow an investor in a flowthrough entity to invest the entire amount of gains from such sales without regard to

losses[20] and permit the taxpayer to elect to change the beginning of the investment period to run from one of the following three dates: (1) the end of the entity's tax year, (2) the date of the sale of each asset, or (3) the date that the return for the entity realizing the gain would be due, without regard to extensions.[21]

Partnership and other flowthrough entity gains

To address concerns of taxpayers regarding the possible late receipt by them of Forms K-1 and other reports issued by flowthrough entities, partners in a partnership, shareholders of an S corporation, and beneficiaries of estates and non-grantor trusts are provided the option by the Final Regulations, as noted above in connection with the deferral of Sec. 1231 gains, to start the 180-day investment period on the due date of the entity's tax return, not including any extensions.[22]

Gains of shareholders of regulated investment companies (RICs) and real estate investment trusts (REITs)

The Final Regulations provide that the 180-day investment period generally starts at the close of the shareholder's tax year and that gains can, at the shareholder's option, also be invested based on the 180-day investment period starting when the shareholder receives capital gains dividends from a RIC or REIT.[23]

Gains from installment sales

In an area where the Proposed Regulations had been completely silent, the Final Regulations now provide that gains derived from installment sales, in years following such sales, may be invested when received, even (surprisingly) if the installment sale took place prior to January 1, 2018, the effective date of the law governing investments in QOZs.[24] In the case of installment sale gains, the 180-day

reinvestment period may constitute, at the taxpayer's election, either a separate 180-day period for each payment received by the taxpayer during the year, or there can be a single reinvestment period beginning on the last day of the taxable year.[25]

Gains from sales of QOZBP to a QOF or a QOZB

In one of the few non-taxpayer friendly policy decisions to be found within the Final Regulations, the Treasury and the IRS determined that a taxpayer cannot sell an asset to a QOF or a QOZB and then contribute the gain derived therefrom to a QOF.[26] Under traditional tax principles, the circular movement of the cash (i.e., from the entity to the seller, who then recontributes such cash to the entity) would be disregarded and the transaction recharacterized as a contribution of property in exchange for an ownership interest, rather than as a sale.[27] Inasmuch as qualified property of a QOF or a QOZB can only be acquired by purchase and not by contribution, the Final Regulations prohibit such transactions.

Expansion of sales eligible for 10-year gain exclusion

The Proposed Regulations provided that an investor could only elect to exclude gains from the sale of qualifying investments or property sold by a QOF operating in partnership or S corporation form, but not property sold by a subsidiary entity. The Final Regulations instead provide that capital gains from the sale of property by a QOZB that is held by a subsidiary entity may also be excluded from income as long as the investor's qualifying investment in the QOF has been held for 10 years.[28] The Final Regulations also clarify that the exclusion is available to other gains, as well, such as distributions by a corporation to shareholders or a partnership to a partner, that are treated as gains from the sale or exchange of property (other than inventory) for Federal income tax purposes.[29]

Inclusion events that trigger recognition of deferred gain

The Final Regulations adopt the principle articulated by the Proposed Regulations that require an investor in a QOF to recognize a deferred gain prior to December 31, 2026, on a dollar for dollar basis, in the case of an "inclusion event". The term "inclusion event" is defined as a reduction, in whole or in part, of the investor's direct equity investment in the QOF or a distribution of property with a fair market value in excess of the investor's basis in the QOF.[30]

Some examples of inclusion events in the Final Regulations are obvious (e.g., the termination or liquidation of a QOF), while others are less so (e.g., a tax-free interspousal transfer of a QOF incident to a divorce or a transfer of a QOF interest by gift).[31]

The Final Regulations also spell out instances of transfers of QOF interests that do not represent inclusion events. In part, these involve transfers at death of an investment in a QOF, qualifying Sec. 381 transactions arising from tax-free reorganizations, the making or revoking of an S election, and a transfer under Sec.721 of an interest in a QOF to a partnership in exchange for an interest in the transferee partnership.[32] All of these examples of non-inclusion events share in common the continuity of investment in the QOF on the part of the investor (or the investor's heirs), rather than a monetization of such investment.

Revisions and adoption of major operational rules within the Final Regulations

Liberalization of "substantial improvement" rule

In general, used property purchased by a QOF or QOZB does not constitute qualified property unless it is "substantially improved", and to meet this requirement, a QOF or a QOZB must spend as much or more than their basis in the used property (but

not land) on additions to basis within a 30-month period.[33] The approach of the Proposed Regulations was to compute these additions on a building-by-building basis, even though the statutory provision (Code Sec. 1400Z-2(d)(2)(D)(ii)) refers to additions to basis "with respect to" the used property, suggesting a broader treatment.

The Final Regulations have adopted a broader, "aggregate" rule, and provide two sets of substantial improvement rules. Neither is exclusive of the other, and both might apply at the same time.

The first set of rules allows the cost of new assets to apply towards the doubling of basis requirement, provided the rehabilitated building and the new, purchased assets are used in the same trade or business in the opportunity zone or in a contiguous opportunity zone, and the new assets improve the functionality of the used assets.[34] An example in the Final Regulations demonstrates that the cost of new furniture for use in a used building can be part of the substantial rehabilitation of the building. Thus, a $1000 hotel could pass the test with a $900 rehabilitation and the purchase of $110 of mattresses and furniture for use in the hotel.[35] On the other hand, the cost of a new apartment building cannot count towards the rehabilitation of a hotel, because these are different trades or businesses.[36]

The second set of rules allows improvements to buildings on contiguous parcels, or buildings located on a single parcel and transferred in a single deed to be aggregated and treated as if they were a single property. To aggregate under this rule, all of the buildings must receive some rehabilitation. They must also be operated exclusively by one QOF or QOZB, they must share common business elements like human resources and accounting, and they must have a common or interdependent trade or business.[37] For example, assume two adjacent buildings have starting bases of $400 and $500 and pass the other tests required to aggregate. Further

suppose that a QOZB undertakes a rehabilitation of $375 for the first building and $600 for the second building. Under the Proposed Regulation, the rehabilitation of the first building would have failed to meet the doubling of basis test. However, under the Final Regulations, the total rehabilitation, $975, is more than the aggregate basis, $900, and the rehabilitation passes the substantial improvement requirement.[38]

Vacancy period reduced to allow a building to qualify as original use

The Final Regulations reduce the five year vacancy requirement that had been provided under the Proposed Regulations in order to qualify the property as original use and thereby avoid the substantial improvement requirement. The vacancy requirement is now one year if the property had been vacant for at least one year prior to the QOZ being designated and remains vacant through the date of purchase; for other vacant property, the proposed five year vacancy requirement is reduced to three years.[39] In addition, property involuntarily transferred to local government control is included in the definition of the term vacant, allowing it to be treated as original use property when purchased by a QOF or QOZB from the local government.[40]

Modifications of Safe Harbor Working Capital Rule

As discussed above, a QOZB may not hold 5 percent or more of its assets in the form of cash (or other "nonqualified financial property"). The Proposed Regulations, however, had permitted "working capital" to exceed this limitation, provided the QOZB had created a budget to expend the funds within a 31-month period to develop a property or a business within the QOZ. The Final Regulations maintain the 31-month written plan rule,[41] and they now permit a qualified opportunity zone business to apply subsequent 31-month working capital safe harbors up to a maximum 62-month period, provided that

each 31-month period itself satisfies the requirements, and they are part of an integral plan.[42] The Final Regulations also allow tolling attributable to a governmental permitting delay, as did the Proposed Regulations.[43] The Final Regulations also add favorable treatment where the taxpayer reasonably expects that a used property will become QOZBP within 30 months, and they treat property that is being rehabilitated as qualifying property during such a period, regardless of whether it is held at the QOF or QOZB level.[44]

Leased property may constitute QOZBP

The Final Regulations adopt the position of the Proposed Regulations that permit leased property, whether leased from a related or an unrelated party, to represent QOZBP if the lease is entered into after December 31, 2017 and its terms are arms length.[45]

This significantly expands the statute, which provides that, to qualify as QOZBP, property must be "acquired by the qualified opportunity fund by purchase".[46] Also, very favorably, the Final Regulations further provide that leased property need not meet the "original use" requirement (except as discussed in the next paragraph).[47]

In the case of a lease from a related party to a QOF or a QOZB, two additional limitations exist. First, the lessee may not prepay on the lease for a period of use that exceeds 12 months,[48] and second, in order for personal property to qualify as QOZBP, the property must either meet the original use requirement, or, alternatively, during the 30-month period commencing with the inception of the lease, the QOF or QOZB must acquire other tangible QOZBP with a value equal to the value of the leased property (and that property can be wholly unrelated to the leased property).[49]

Finally, if at the time a lease for real property is entered into, whether the lease is from a related or an unrelated party, there is an "expectation" that the property will be purchased by the QOF or the QOZB at a price other than the property's fair market value as of the time of purchase, the property is not QOZBP.[50]

Easing of prohibition of triple net leases

The IRS has traditionally viewed a triple net lease (i.e., a lease where the tenant is responsible for the maintenance, property taxes and insurance costs of the occupied space) as an investment, rather than a trade or business, which is inconsistent with the statutory requirement that QOZBP must be used by a QOF or QOZB in a "Section 162 trade or business". The Proposed Regulations provided unequivocally that a triple net lease did not constitute a trade or business for this purpose,[51] but the Final Regulations, while restating the same principle,[52] are more flexible and provide that some degree of landlord participation in a building's operations might serve to mitigate the prohibition.[53] This determination is subjective; the Final Regulations provide an example of one building with multiple tenants, where one tenant is under a triple net lease and the others are not, and concludes that the landlord is conducting a trade or business.[54] It is possible that future guidance, perhaps under the qualified business income regulations of Section 199A, may provide some clarification, but, in the meantime investors in a QOF should not knowingly buy into an IRS audit and should be careful to avoid triple net lease offerings.

Definitions of location and "use" of intangible property

The statute requires that for a business to qualify as a QOZB, a "substantial portion" of the intangible property of the entity must be used in the active

conduct of the trade or business within the QOZ. [55] The Proposed Regulations had defined the term "substantial portion" for this purpose as 40 percent, which the Final Regulations leave unchanged and further provide that intangible property qualifies as "used" in the QOZ if: (1) the QOZB's use of the intangible property is normal, usual, or customary in the conduct of the trade or business, and (2) the QOZB's use contributes to the generation of gross income for the trade or business.[56]

Liberalization of "sin business" prohibition

The Preamble to the Final Regulations points out that the statutory sin business prohibition is only applicable to QOZBs, and not to QOFs.[57] Moreover, the Final Regulations provide that a QOZB may have less than 5 percent of its property leased to a sin business;[58] for example, a QOZB conducting a hotel business may lease less than 5 percent of its space to a space that provides tanning service.[59]

What the Final Regulations Do Not Cover

Although the Final Regulations expend 544 pages in explaining how to invest in a QOF and conduct a qualifying business within a QOZP utilizing QPZPB, as well as how a penalty is imposed on QOFs for failure to abide by the qualifying property percentage requirements, nowhere do they explain under what circumstances a QOF will be involuntarily decertified.[60] It is astonishing that after three sets of regulations, investors are still unaware of under what egregious circumstances will an auditor be prompted to go beyond a penalty and propose complete disqualification of a QOF, which, obviously, would result in the invalidation of investor deferrals and other anticipated tax benefits. Perhaps no such circumstances exist, but in light of the complexity of the rules and the likelihood of multiple footfalls, that seems difficult to accept.

[1]T.D. 9889. The Final Regulation were printed in the Federal Register on Jan. 13, 2020 at 85 F.R. 1866 and take effect on Mar. 13, 2020 for taxable years beginning after that date. Id..
[2] The Proposed Regulations subsequently were printed in the Federal Register on Oct. 29, 2018 and May 1, 2019, at respectively, 83 F.R. 54279 and 84 F.R. 18652.
[3] For that part of a taxpayer's first taxable year ending after Dec. 21, 2017 that began on Dec. 22, 2017, and for taxable years beginning after Dec. 21, 2017 and on or before Mar. 13, 2020, taxpayers may choose either to apply the Final Regulations or the Proposed Regulations (except for Prop. Regs. 81.1400Z2(c)-1, dealing with the 10-year gain exclusion, discussed below), so long as the application is consistent. Summary of Final Regulations (herein, "Preamble") at 2.
[4] See "New Qualified Opportunity Zone Guidance Released" (Oct. 24, 2018) and "Treasury Releases Second Round of Proposed Opportunity Zone Regulations" (Apr. 22, 2019).
[5] Code Sec. 1400Z-2(a).
[6] Code Sec. 1400Z-2(b)(2)(B)(iii).
[7] Code Sec. 1400Z-2(b)(2)(B)(iv). A qualifying investment cannot have been held for the requisite 7 years before December 31, 2026 if it was made after December 31, 2019.
[8] Code Sec. 1400Z-2(c).
[9] Code Sec. 1400Z-2(d)(1).
[10] Code Sec. 1400Z-2(d)(2)(A).
[11] Code Sec. 1400Z-2(d)(3)(A).
[12] Code Sec. 1400Z-2(d)(2)(D)(i)(I) (purchase); Code Sec. 1400Z-2(d)(3)(A)(i) (lease).
[13] Code Sec. 1400Z-2(d)(2)(D)(i)(I).
[14] Code Sec. 1400Z-2(d)(2)(D)(i)(II).
[15] Code Sec. 1400Z-2(d)(2)(D)(i)(III).
[16] Code Sec. 1400Z-2(d)(3)(A)(ii), incorporating the requirements of Code See 1397C(b)(2) and (4). With regard to the 50 percent gross income test, the Final Regulations adopt the position of the Proposed Regulations that the test can be met by: (i) at least 50 percent of the services performed for the trade or business are performed in a QOZ based on hours of

service or measured by compensation paid; (ii) the tangible property of the trade or business located in a QOZ and the management or operational functions performed there are each necessary for the generation of at least 50 percent of the gross income of the QOZB; or (iii) based on all of the facts and circumstances, at least 50 percent of the gross income of the QOZB is derived from the active conduct within the QOZ of the trade or business. See Regs.§1.1400Z2(d)-1(d)(3)(A)-(D).
[17] See 1397C(b)(8).
[18] Reg. § 1.1400Z2(d)-1(d)(3)(v).
[19] Code Sec. 1400Z-2(d)(3)(A)(iii), incorporating Code Sec. 144(c)(6)(B).
[20] Reg. §1.1400Z2(a)-1(a)(11)
[21] Reg. §1.1400Z2(a)-1(c)(8), (9).
[22] Id.
[23] Reg. §1.1400Z2(a)-1(b)(7)(ii).
[24] Reg. §1.1400Z2(a)-1(a)(11)(viii)
[25] Id.
[26] Reg. §1.1400Z2(a)-1(a)(11)(v)
[27] See Rev. Rul. 83-142, 1983-2 C.B. 68; Rev. Rul. 78-397, 1978-2 C.B. 150.
[28] Reg. §1.1400Z2(c)-1(b)(2)(ii).
[29] Id.
[30] Regs. §1.1400Z2(b)-1(c)(1)(i), (ii).
[31] Reg. §1.1400Z2(b)-1(c)(2)(i) (QOF termination or liquidation); Regs. §1.1400Z2(b)-1(c)(3) (gift or incident to divorce).
[32] See Reg. §1.1400Z2(b)-1(c)(4) (death); - 1(c)(10) (qualifying Sec. 381 reorganization); - 1(c)(7)(i)(A) (electing or revoking S status); -(c)(6)(ii)(B) (Sec. 721 contributions).
[33] Reg. §1.1400Z2(d)-2(b)(4)(i).
[34] Reg. §1.1400Z2(d)-2(b)(4)(iii)(A).
[35] Reg. §1.1400Z2(d)-2(b)(4)(iii)(D)(Ex. 1).
[36] Reg. §1.1400Z2(d)-2(b)(4)(iii)(D)(Ex. 2).
[37] Reg. §1.1400Z2(d)-2(b)(4)(iii)(A).
[38] The Final Regulations caution that if the taxpayer avails itself of the aggregation rule, the non-original use real property must be improved by more than an “insubstantial” amount. Reg. § 1.1400Z2(d)-2(b)(4)(iii)(B).
[39] Reg. §1.1400Z2(d)-2(b)(3)(iii)(B).

[40] Reg. §1.1400Z2(d)-2(b)(3)(v).
[41] Reg. §1.1400Z2(d)-1(d)(3)(v)(B).
[42] Reg. §1.1400Z2(d)-1(d)(3)(v)(F).
[43] Reg. §1.1400Z2(d)-1(d)(3)(v)(C).
[44] Reg. §1.1400Z2(d)-1(d)(3)(viii).
[45] Reg. §1.1400Z2(d)-2(c)(i)(1), (2).
[46] Code Sec. 1400Z-2(d)2(D)(i)(I).
[47] Reg. §1.1400Z2(d)-2(c)(3)(iii)(A).
[48] Reg. §1.1400Z2(d)-2(c)(3)(i) and (iv).
[49] Reg. §1.1400Z2(d)-2(c)(3)(ii).
[50] Reg. §1.1400Z2(d)-2(c)(4).
[51] Prop. Regs. §1.1400Z2(d)-1(d)(5)(ii)(B)(2) (second sentence)
[52] Reg. §1.1400Z2(d)-1(d)(3)(iii)(B).
[53] Reg. §1.1400Z2(d)-1(d)(3)(iii)(C) (Ex. 2)(ii)).
[54] Id.
[55] Code Sec. 1397C(b)(4).
[56] Reg. §1.1400Z2(d)-l(d)(3)(ii)(A), (B).
[57] Preamble at 259. See Code Sec. 1400Z-2(d)(3)(A)(iii).
[58] Reg. §1.1400Z2(d)-1(d)(4)(ii), (iii).
[59] Reg. §1.1400Z2(d)-1(d)(4)(iv)(A) (Ex. 1).
[60] Reg. §1.1400Z2(d)-1(a)(3) addresses voluntary self-decertification as a QOF, but Reg. §1400Z2(d)-(a)(4), captioned “Involuntary decertification” only provides ”[Reserved]”.
