Insights: Alerts

Final IRS Rules Spur Development of New Opportunity Zone Funds

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On December 19, 2019, the Treasury Department released the final regulations implementing the opportunity zone provisions of the Tax Cuts and Jobs Act. These regulations clarified and expanded proposed regulations issued October 29, 2018 and April 17, 2019 after a period of public comment. This legal alert discusses select topics addressed by the final regulations.

As of early 2020, over 500 qualified opportunity funds ("QOFs") totaling almost $70 billion of capital gains eligible for tax-advantaged treatment under the opportunity zone legislation and regulations were created. The majority of these funds were established for real estate investments, and at least 15 of the QOFs were designated for energy investments in designated opportunity zones. These final regulations will likely spur the formation of additional QOFs for investment in opportunity zone projects by providing clarity on previously unanswered questions and applicable tests.

10-Year Exclusion Election

The most important point of clarification in the final regulations concerns the tax treatment of the disposition of property by QOFs structured as partnerships and S corporations ("Passthrough QOFs"). The proposed regulations provided an election to investors holding interests in Passthrough QOFs for more than 10 years to exclude capital gains from the sale of assets by the QOF. The proposed regulations left open two questions: whether (i) other types of gains, including Section 1231 gains and depreciation recapture were eligible for exclusion, and (ii) dispositions of assets held by Passthrough QOFs were eligible for the exclusion. The open questions could lead to different tax treatment depending on the structure of the disposition. The final regulations expanded this election to include all gains from the sale of assets (including Section1231 gains and depreciation recapture), other than sales of inventory, by a Passthrough QOF and any partnership owned by the Passthrough QOF.

In addition, the final regulations provide that the 10-year exclusion election is permitted where a QOF structured as a corporation makes a distribution of property to a shareholder that is in excess of the shareholder's basis in the corporation.

Accordingly, under the final regulations a broad array of transactions qualify for tax-privileged treatment after the 10-year holding period, including:

- Property sold by a Passthrough QOF, other than inventory, including ownership interests in entities held by the Passthrough QOF;
- Property sold by a qualified opportunity zone business ("QOZB") structured as a partnership in which a Passthrough QOF invests;
- Interest in a QOF sold by an investor; and

- Distributions of property by a corporate QOF to investors in excess of basis.

This rule obviates the need for single-project Passthrough QOFs by allowing the tax-free sale of assets or interests held, directly or indirectly through one or more partnerships or other passthrough entities, by the Passthrough QOF. In addition, disposition of assets which were not qualified opportunity zone property or QOZB property, but were nonetheless part of a properly-certified QOF or QOZB, respectively, would still qualify for tax-free treatment.

Substantial Improvement Test

A fund will qualify as a QOF if at least 90% of its assets constitute qualified opportunity zone property. For this purpose, "qualified opportunity zone property" is property that is either "qualified opportunity zone stock," "qualified opportunity zone partnership interests," or "qualified opportunity zone business property." For an interest in an entity to qualify as "qualified opportunity zone stock" or a "qualified opportunity zone partnership", substantially all (70%) of such entity's assets must be "qualified opportunity zone business property."

Property is qualified opportunity zone business property if, among other requirements, the property's original use in the qualified opportunity zone commences with the QOF (or an entity owned by the QOF) ("original use property"), or the QOF (or an entity owned by the QOF) "substantially improves" the property. A property is "substantially improved" if, within the 30-month period beginning after the date of acquisition, additions to basis with respect to the property exceed the adjusted basis of the property when it was acquired.

The final regulations broaden the scope of eligible basis-adding improvements by allowing taxpayers to: (i) treat certain purchased buildings as a single property if the buildings are located in the same qualified opportunity zone or a single series of contiguous qualified opportunity zones (an "eligible building group"); or (ii) to elect to use "original use property" that improves the functionality of a single property, for purposes of determining whether additions to basis satisfy the "substantial improvement requirement."

Aggregation of Buildings in an Eligible Building Group.

The final regulations permit taxpayers to aggregate the basis of buildings in an eligible building group in two situations for purposes of determining whether the "substantial improvement" requirement has been met.

- *Single Property, Multiple Buildings, Single Deed.* All buildings comprising an eligible building group that are located entirely within the geographic borders of a parcel of land described in a single deed may be treated as a single property.
- *Multiple Properties, Multiple Buildings, Multiple Deeds.* All buildings comprising an eligible building group located entirely within contiguous parcels of land described in separate deeds may be treated as a single property to the extent that each building is operated as part of one or more trades or businesses that:
    - are operated exclusively by the QOF or QOZB;
    - share facilities or significant centralized business elements (e.g., personnel, accounting, legal, manufacturing, purchasing, HR, or IT resources); and
    - are interdependent with, or operated in coordination with or reliance upon one or more trades or businesses

Under this aggregation rule, two eligible buildings with basis $100 and $200, and with improvements of $90 and

$250, respectively, would pass the substantial improvement test under the final regulations ($90 + $250 = $360 > $300), but the first building would fail the test by itself ($90 < $100).

Aggregation of Original Use Property that Improves Functionality.

The final regulations permit QOFs or QOZBs to include as additions to basis the cost of original use assets that otherwise would qualify as QOZB property if the assets:

- are located in the same qualified opportunity zone (or a contiguous qualified opportunity zone);
- are used in the same trade or business as the non-original use asset; and
- improve the functionality of the non-original use assets; and if the non-original use property is real property, then the real property must be improved by more than an insubstantial amount.

The final regulations decline to state a bright-line threshold for "insubstantial", but as one example, improvements to the land, such as an irrigation system for a farming business or grading of the land that facilitates the use of the land in a trade or business of the QOF or QOZB is more than an insubstantial amount of improvement.

Under this aggregation rule, for example, a QOF or QOZB seeking to rehabilitate a hotel could include the cost of mattresses, linens, etc. as basis-increasing improvements to the hotel. However, the same QOZ or QOZB would not be able to include the cost of an apartment building that is operated in a trade or business separate from the hotel business.

Restriction on Reinvestment of Proceeds from Sales of Property to QOFs and QOZBs

Citing the step doctrine and circular cash flow principles, the preamble to the final regulations provides that gains from the sale of property to a QOF is not eligible gain for purposes of making a qualifying investment in the QOF if such sale is part of a plan to reinvest the gain into the purchasing QOF. Instead, such sale and reinvestment would be re-characterized as a contribution of property by the seller to the QOF in exchange for an interest in the QOF and thus would not be treated as a "qualifying investment." Furthermore, the final regulations suggest that even if such seller sold the property to a QOZB, and the taxpayer reinvested the proceeds into the QOF which owns the purchasing QOZB, the transaction may still be treated as a contribution, and therefore, a non-qualifying investment in a QOF, regardless of whether the QOF later transfers the investment into the QOZB.

In addition, because the above transaction would be recast as a "contribution", the property that was deemed contributed would not be treated as "qualified opportunity zone business property" because it was not purchased.

Expansion and Clarification of Working Capital Safe Harbor

QOZBs must generally have less than 5% of its property in non-qualified financial property (NQFP). NQFP includes stock, debt, partnership interests, options, futures contracts, etc., but excludes a "reasonable amount of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less". The proposed regulations included a 31-month safe harbor which deems working capital "reasonable" if the following three conditions are satisfied:

- The amounts of working capital assets are designated in writing for the development of a trade or business in a QOC, including, when appropriate, the acquisition, construction, and/or substantial improvement of tangible

property in a QOZ;
- There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets over a period not exceeding 31 months from the date of the receipt of the assets; and
- Working capital assets are actually used in a manner that is substantially consistently with the above written schedule.

The final regulations provide that a single business can benefit from more than a single application of the working capital safe harbor, provided that each successive use of the safe harbor independently satisfies all of the requirements of the "working capital safe harbor" set forth above. If the application for the use of successive working capital safe harbors applies to the same item of tangible property (such as a building) held by that business, then successive use of this safe harbor is limited to one additional 31-month safe harbor period (for a maximum of 62 months of protection). In order for an item of tangible property to qualify for a subsequent 31-month safe harbor:

- the application for the successive working capital safe harbor must satisfy all of the requirements for the working capital safe harbor set forth above;
- the working capital from an expiring 31-month safe harbor must have been spent in accordance the written schedule applicable to such expiring period; and
- Subsequent infusions of working capital must form an integral part of the plan covered by the initial 31-month working capital safe harbor period.

Start-up QOZBs can use utilize this safe harbor to prevent multiple infusions of capital over a long period of time from upsetting their eligibility as a QOZB.

Section 1231 Gain

Section 1231 property is real or depreciable business property held for more than one year, and Section 1231 gain or loss is the gain or loss from the sale of such Section 1231 property. Under the proposed regulations, only net Section 1231 gains for a taxable year (Section 1231 gains are greater than Section 1231 losses) were treated as gains eligible for deferral under the opportunity zone program. In addition, the proposed regulations provided that the 180-day period for investing net Section 1231 gains into a QOF began on the last day of the calendar year in which the gains were recognized.

The final regulations revised these rules and provide that eligible gains include gross Section 1231 gains not required to be characterized as ordinary income under Sections 1245 and 1250, regardless of whether Section 1231 would characterize such gain as capital gains or ordinary income. In addition, the final regulations provide that the 180-day period begins on the date of the sale or exchange giving rise to the gain. These two changes in the final regulations allow for taxpayers realizing Section 1231 gain to invest such gain in a QOF as soon as the funds are available.

For more information, please contact any of the attorneys listed below.

Related People





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