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Opportunity Zones

Applying the Opportunity Zone Program in the Wake of the COVID-19 Pandemic

The Treasury, in December 2019, released final regulations for the opportunity zone program, refining and clarifying the proposed regulations, which is especially helpful in light of the economic uncertainties caused by the COVID-19 pandemic. However, numerous unresolved questions remain.

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Introduction

In December 2019, the Treasury released final regulations for the opportunity zone program (the "Final Regulations") to refine and clarify certain aspects of the first two sets of proposed regulations[1] and to make the rules easier to follow and understand.

The opportunity zone program was created as part of the Tax Cuts and Jobs Act signed into law in December 2017 as a new tax incentive program to spur economic growth and investment in designated distressed communities called opportunity zones ("OZs").

The OZ incentive program allows for the deferral of certain capital gains to the extent such gains are 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 ten years. Those tax benefits available under the OZ program include the following:

- Deferral of taxation on original capital gain reinvested into a QOF, until December 31, 2026 (or earlier, if sold).
- Reduction of capital gains tax (at end of deferral period), by 10% if QOF investment has been held for five years.
- By 15% if QOF investment has been held for seven years (the seven-year window expired on December 31, 2019).
- No taxation on gain from the sale of an investment in a QOF if held for ten years.
- Tax benefits are only for reinvested gain; not for after-tax cash investment.

In light of the unprecedented economic challenges presented by the COVID-19 outbreak, taxpayers with short-term or long-term capital gain income generated in 2019, or in early 2020, can use the OZ program to invest the qualified gains in a QOF for a period of time.

As some investors reevaluate their commitments to qualified opportunity zones ("QOZs") in light of the COVID-19 global pandemic, they may enjoy some level of favorable tax treatment in 2020 if they decide to liquidate their capital from the funds. While investors would likely consider multiple variables before deciding to take money out of OZs (i.e., the extent fund withdrawal is allowed, market stability, and investor ability to write off losses), the Code has some advantages for those seeking to opt out of funds.

To the extent individuals had deferred capital gains by committing them to QOFs in previous tax years, the gains would be recognized in 2020 if those investors decided to liquidate their investment in 2020. Such liquidation would result in those investors' ability to offset their capital losses generated in 2020, thereby reducing their tax liabilities. While such result may not be the original tax benefit investors were looking for when they invested in opportunity funds, it may be more beneficial than sustaining a capital loss in 2020 because those losses cannot be carried back.

The Final Regulations clarify that individuals would not be subject to interest or other kinds of penalties if they chose to liquidate their investments early. The OZ program was designed to offer tax relief for investments in low-income communities and does not levy interest-laden penalties on investors who choose to withdraw capital gains from funds. The OZ program also allows a restart on the clock on the 180-day window for reinvesting in other funds without losing out on the OZ program's favorable tax treatment.

Once the capital gains have been reinvested into a QOF and then dropped into a qualified opportunity zone business (“QOZB”), taxpayers may have up to 62 months to reinvest the proceeds into various QOZ projects. This extended reinvestment period is particularly useful in light of the uncertainty in the current markets.

Given the market's current volatility, investors may be willing to realize losses in 2020 to offset previously deferred gains. Note that the IRS may challenge attempts to offset gains and losses by liquidating OZ investments to determine if those individuals lacked bona fide, good-faith intentions to follow through on those commitments (in line with the anti-abuse provisions discussed hereinafter).[2]

The Final Regulations became effective March 16. The new rules give taxpayers increased flexibility and an extension of time when it comes to determining when the 180-day capital gain reinvestment countdown begins for purposes of meeting the QOF deadline.

COVID-19 update.

The IRS issued Notice 2020-23 which grants investors whose deadline falls between April 1 and July 15, 2020 automatic relief from the 180-day investment requirement. Accordingly, QOFs are a remarkable opportunity for high net worth individuals to defer gain and subsequently exclude further gain based on the appreciation of their investment in an opportunity zone. This summary highlights certain major clarifications and additional flexibility found in the Final Regulations. It also points out certain unresolved matters.

Changes Related to Eligible Gains

Deferral of gross Section 1231 gains.

"Section 1231 assets" are unique assets for purposes 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" Section 1231 gains from the sale of business property (without regard to Section 1231 losses) in qualified QOFs.[3] This enables more Section 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 now begins on the date of the sale of the underlying asset.[4] Investors do not have to wait until the end of the tax year for the 180-day investment period to begin, eliminating the issue of unnecessarily delaying or stalling of planned OZ investments. This is a beneficial change for investors.

For example, if an investor has $1 million of gain on January 7th and $500,000 of a Section 1231 loss in March, the deferral of that entire $1 million of capital 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 tax 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).

Although the Final Regulations arguably leave open the question of 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.

COVID-19 structuring point.

Individuals interested in “cashing out” their investments in OZs in 2020 may also benefit from the ability to reinvest in other QOFs within a 180-day window—they would effectively be recognizing a capital gain in 2020, and the 180-day window in which investors can place gains into OZs begins whenever a capital gain is recognized. That may be an attractive option for individuals who have become dissatisfied with the funds they have invested in. However, note that there may be diminishing returns if investors repeatedly liquidated gains that are parked in QOFs only to redeploy them into other funds later, since investors may miss out on the increased levels of the five or seven-year stepped-up basis.

One provision of the original opportunity zone legislation provides a 15% step-up in basis for investments made before December 31, 2019, if those investments are held for seven years. After that window closes, investments can qualify for a 10% step-up in basis if they are held for five years. The ability to defer capital gains by investing in opportunity funds is set to expire in 2026, so the deadline for claiming a 10% step-up in basis is December 31, 2021.

Gains from sale of property to an unrelated QOF or its QOZB.

A recurring question has been to what extent, if at all, may an investor sell property to a QOF or QOZB, then contribute an amount equal to the gain on the sale to the QOF, and treat the gain as "eligible gain" and the purchase as a "purchase" from an unrelated party?

Although the Final Regulations allow the QOZB to sell land to another QOZB even if they are related parties, any gains would not be eligible to be invested in the second QOZB by investors of the QOZB if the investors are related (and possibly by unrelated investors of QOZB in certain circumstances, as discussed below).[5] With respect to the second QOZB, the land would *not* be considered qualified property in the hands of the second QOZB if purchased from a related QOZB—even if the relatedness happened *subsequent* to the purchase of the land in a series of steps.

If a taxpayer/investor sold property to an unrelated QOF and then invested the amount of the sales proceeds in the same QOF, that sequence of transactions could be characterized under "circular cash flow" principles, as if the taxpayer/investor contributed the property directly to the QOF (and each transfer of the sales proceeds would be disregarded) and the acquired property would not qualify as qualified opportunity zone business property ("QOZB property").

The Final Regulations confirm that generally applicable federal income tax principles would require this result if, under the facts and circumstances, the consideration paid by the QOF or by a QOZB returns to its initial source as part of the overall plan. Under the step transaction doctrine and circular cash flow principles, the circular movement of the consideration in such a transaction is disregarded and the transaction is treated as a transfer of property to the purchasing QOF for an interest therein or, if applicable, as a transfer of property to a QOF for an interest therein followed by a transfer of such property by the QOF to the purchasing QOZB. In other words, property deemed contributed cannot be QOZB property.[6]

The Final Regulations also note that if an eligible taxpayer/investor sells property to, or exchanges property with, an unrelated QOZB as part of a plan that includes the investment of the consideration by the taxpayer/investor back into the QOF that owns the acquiring QOZB, the transaction potentially may be recast or recharacterized as a non-qualifying investment even if the QOF retains the consideration (rather than transferring the consideration to the QOZB).

Structural Benefits to Leasing to Related-Party

Note that the Final Regulations confirm certain structural benefits as to the related-party leasing rules,[7] in that certain restrictions or prohibitions apply to related party sale or exchange transactions that do not apply to related party lease transactions. These benefits should be considered regardless of relatedness of parties to an anticipated transaction(s) based on the open question, discussed above, of whether there need to be related parties for a re-contribution to be ineligible. To the extent the restrictions in the above paragraph affect or possibly affect the intended activities of the QOZBs, the parties may consider structuring their relationship or certain aspects of their relationship as a lessor-lessee (as opposed to a buyer-seller). For example, possible gain exclusion under the Final Regulations may be available if, instead of a sale of the land, the intended transaction is structured as a lease of the land with a FMV purchase option after ten years (calculated from the date of the original QOF investment), assuming the land is not considered property sold in the ordinary course of business that would result in ordinary gains not eligible for deferral (as discussed above).

Impact of "Step Transaction" Doctrine and "Circular Cash Flow" Principles

The preamble to the Final Regulations warns that if such transaction was successfully challenged under the "step transaction" doctrine and "circular cash flow" principles, the transaction would be treated for federal income tax purposes as a transfer of property to the purchasing QOF for an interest therein or, if applicable, as a transfer of property to a

QOF for an interest therein, followed by a transfer of such property by the QOF to the purchasing QOZB.[8] In either case, the investor would not be treated as investing eligible gain in the QOF, and the property would not be QOZB property.

To reiterate, there is confusion over whether this could be the result regardless of whether the taxpayer became "related" to the QOF following its investment in the QOF because the preamble discussion does not address whether the taxpayer became related. (Although the preamble discussion does refer to an example in the anti-abuse section of the Final Regulations whereby the taxpayer does become related following its investment, this example implies that the transaction was not valid because of the unitary plan to become related.)

To conclude, the step transaction and circular cash flow principles are generally not applied if a transaction has independent economic significance, and gains from sales or exchanges with QOFs or QOZBs should be able to be invested into QOFs or QOZBs where the seller-investor is not "related" after its investment.

Changes Related to Qualified Opportunity Zone Business Property

Working capital safe harbor.

In order for the QOZB to be a "qualified opportunity zone business" as described by the Final Regulations, the QOZB must show that:

> ((i)) substantially all of its tangible property (owned or leased) is "qualified opportunity zone business property" as described by the Final Regulations;
>
> ((ii)) at least 50% of the total gross income derived by the QOZB comes from the active conduct of a qualified business within an OZ;
>
> ((iii)) less than 5% of its property is attributable to nonqualified financial property ("NQFP"); and
>
> ((iv)) a substantial portion, which means at least 40%, of the QOZB's intangible property is used in the active conduct of its business within an OZ.[9]

The "substantially all" threshold with respect to both the required amount and use of tangible property owned or leased by a QOZB is 70%. Although 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% 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% tangible property standard." Accordingly, working capital must be treated as 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.

There are no restrictions on the QOZB selling land. However, the QOZB's NQFP must be limited to less than 5% of unadjusted basis in the assets.[10] If the land sale can be construed as a sale in the ordinary course of business, then the receivable will not be NQFP (and any gains from such sale will be treated as ordinary gains not eligible for deferral).

Accordingly, the QOZB can sell real property to the second QOZB for cash as long as the QOZB utilizes that cash within the business to pay off existing debt or to fund QOZB operations. If the QOZB was to distribute the cash from the real property sale to the QOF, and then the QOF distributed that cash to investors, it would be viewed as a "return of capital." Although not a violation of the Final Regulations, note that such a distribution to a QOF investor from a land sale could be an inclusion event to the extent that the distributed property has a fair market value (FMV) in excess of the investor's basis. Also note that a QOF investor's transfer of cash or other property to the QOF partnership in an otherwise eligible contribution may be recharacterized as a non-qualifying investment to the extent that any such distribution is treated as a disguised sale under the rules provided under Section 707 (i.e., made within a two-year period).

Extended 62-Month Safe Harbor

The Final Regulations provide a 62-month safe harbor—rather than a simple 31-month safe harbor (as was provided under the proposed regulations applicable to OZs)—and a QOZB can choose to apply a subsequent 31-month working capital safe harbor to tangible property for a maximum 62-month period (i.e., a QOZB can choose to "piggyback" two successive 31-month safe harbor periods).[11]

For purposes of qualifying for the working capital safe harbor (whether for the 31-month or the expanded 62-month period), the amount of working capital is treated as "reasonable" if:

(1) the amounts of working capital are designated in writing for the development of a trade or business in a qualified OZ, 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).

To use the working capital safe harbor in accordance with the Final Regulations, the plan for the project must incorporate these requirements, explicitly and in writing, likely to be prepared by a professional.

A QOZB must receive multiple cash infusions during the initial 31-month period to qualify for a maximum 62-month safe harbor. Specifically, under the 62-month working capital safe harbor, a QOZB can qualify for a 31-month safe harbor period with respect to this QOZB's "first" cash infusion. Upon receipt of a subsequent contribution of cash (subsequent cash infusion), such QOZB may choose both to (i) extend the original 31-month safe harbor period that covered the initial cash infusion, and (ii) receive safe harbor coverage for the subsequent cash contribution for another 31-month period, for a maximum 62-month period (that is, a duration equal to two working capital safe harbor periods), provided that such QOZB satisfies the following two conditions:

(1) the subsequent cash infusion must be independently covered by an additional working capital safe harbor; and

(2) the working capital safe harbor plan for the subsequent cash infusion must form an integral part of the working capital safe harbor plan that covered the initial cash infusion.[12]

Cash received by the QOF from a capital transaction (e.g., sale or refinancing) and then distributed to investors before two years could be construed as a "disguised sale," thus invalidating the original deferral to the extent the distribution that is treated as a disguised sale. Note, however, that the Final Regulations confirm that a debt-financed distribution of cash to a QOF investor is generally not an inclusion event if made after two years. However, the QOF should be able to distribute any gains from the land sale to investors. For example, if the original cost of the land was $10 million and the QOF sold it for $15 million, $5 million of the proceeds should be distributable without incident.

Also, the monies received by the QOZB from the land sale could be distributed to the QOF and held in the QOF for up to 12 months, provided such monies are converted from NQFP (i.e., held in eligible temporary investments including debt with a term less than 18 months). The QOF could even lend this cash to the second QOZB if the term does not exceed 18 months.

COVID-19 update.

If a QOZB is located in a QOZ within a federally declared disaster, the QOZB may receive up to an additional 24 months to utilize its working capital assets. Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action, the application for which is completed during the 31-month period.

Anti-Abuse Rules

An additional issue that should be considered is whether an original land purchase may be considered a violation of anti-abuse rules that prohibit holding land for speculative investment provided in the Final Regulations.[13] These anti-abuse rules are intended to prevent the acquisition of land for speculative investment in arrangements inconsistent with the purposes of the Final Regulations, such as if a parcel of unimproved land that is not accompanied by a new capital investment or is not the subject of increased economic activity or output. Before selling any real property, a good faith effort should be made to improve the land by more than an insubstantial amount in a way having more than a transitory effect. Any grading, clearing, and/or paving activities undertaken to improve real property under the plan for the project (as well as under all other facts and circumstances) would be taken into account in applying the speculative land purchase anti-abuse rules.

Working capital as tangible property.

Note that, although 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% 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% tangible property standard.” Accordingly, working capital should be viewed as 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.

Note that if a QOF invests in a QOZB, there is no overall limit on the amount of intangible property (e.g., intellectual property) that the opportunity zone business can own, but a “substantial portion” of its intangible property must be used in the “active conduct of a business” in a zone (though Treasury will need to further define these terms). As to a QOF that directly owns assets in an OZ, only up to 10% of a fund's property (and any cash and property that is not located in an opportunity zone) can be intangible property, but there is no requirement that a percentage of a fund's intangible property be related to the active business of the fund.

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% investment test on a semiannual testing date, the QOF may treat the stock or partnership interest in that business as qualified opportunity zone 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: Aggregation Test

Section 1400Z-2(d)(2)(D) requires that if tangible property was already used in an OZ (“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 qualified opportunity zone business 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 how to measure substantial improvement.[14]

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 “functionality” of the old property it 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 invests 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.[15]

Ambiguity remains relative to 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% 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.[16]

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,” and so is 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% 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.[17]

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% or 70% 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 with 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 to be a different party 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, such as 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 ten years and elects to adjust the basis of their partnership interest to 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 on selling a QOF partnership interest from reducing the OZ 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, so that when a QOF partnership or S corporation sells property, if its owners have held their interest for ten years, such owners can make an election for each tax year to exclude a QOF's gains from all sales or exchanges in the tax 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. However, the Final Regulations did not address the “interim gain problem;” investors have to hold qualifying investment for ten years for gain exclusion.

Special gain “inclusion” rule.

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.[18]

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 OZ 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 provide 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.[19] 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% investment test, expressly rejecting any change to avoid an undefined mathematical result if all of the QOF's property was 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% investment test.

Transfer of qualifying interest by reason of death.

The Final Regulations clarify that 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.[20] This clarification in the Final Regulations came as a surprise; many commentators anticipated 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); instead the Final Regulations confirm that the basis remains at zero with respect to the QOF investment. This rule may complicate estate planning for QOF investors and may discourage certain OZ equity investments by elderly taxpayers.

Changes Related to Property that a QOF Leases

Leased property.

The Final Regulations limit the requirement of proof of an "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.[21] Additionally, the Final Regulations provide that short-term leases of personal property to lessors using the property outside a OZ may be counted QOZB property.

Sin businesses 5% test.

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 set this de minimis threshold at 5%. In other words, a QOZB cannot lease more than 5% 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.

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.[22]

Conclusion

The overall response to Treasury has been positive for clarifying many of the open issues at a critical time in view of the COVID-19 pandemic, but point out that many unresolved questions remain. It is important to spur economic growth and investment in distressed communities in order for the OZ program to be successful and meet its original legislative goals.

As investors brace for current and possibly future economic instability, the tax treatment surrounding QOFs may play a role in their decisions to stick with current commitments or move capital gains into different areas.

[1] The first set was published in October 2018 and the second set was issued in May 2019.

[2] In an example provided in the Final Regulations, the IRS said that individuals who direct their capital gains into opportunity funds they have established, yet have no

intention of actually investing in the projects, would not be eligible to participate in the opportunity zone program.

[3] The Final Regulations provide that a gain is eligible for deferral under Section 1400Z-2(a) if the gain is treated as a capital gain for federal income tax purposes.

[4] Section 1400Z-2(a)(1)(A).

[5] Note that there is some question under the Final Regulations as to whether there need to be related parties (i.e., persons related to each other as described in Sections 267(b) or 707(b)(1), determined by substituting “20%” for “50%” each place the phrase “50%” occurs in those sections) for a re-contribution to be ineligible.

[6] Accordingly, an eligible taxpayer/investor's gain from a sale to or an exchange of property with an unrelated QOF (acquiring QOF), as part of a plan that includes the investment of the consideration received by the eligible taxpayer/investor back into the acquiring QOF, is not “eligible gain” to the “eligible taxpayer/investor” because the transaction would *not* be characterized as a sale or exchange to an unrelated person for federal income tax purposes. Similarly, an eligible taxpayer/investor's gain from a sale to or an exchange of property with an unrelated QOZB (acquiring QOZB) is not eligible gain to the eligible taxpayer/investor if the sale occurs as part of a plan that includes (i) the investment of the consideration received by the eligible taxpayer/investor back into the QOF that owns the acquiring QOZB, followed by (ii) the contribution by the QOF of that consideration to the QOZB. Furthermore, because the transaction is not treated as a “purchase” of tangible property by the QOZB from an unrelated party, the newly acquired property will not qualify as QOZB property.

[7] Section 1400Z-2(e)(2).

[8] The step transaction doctrine is generally not applied if a step has independent economic significance, is not a sham, and was undertaken for a valid business purpose. Property sales can occur between a taxpayer and a QOF or its QOZB with valid business purpose and independent economic significance from taxpayer's following investment in the QOF.

[9] Solely for purposes of applying Section 1397C(e)(1) to the definition of a qualified opportunity zone business under Section 1400Z-2(d)(3), working capital assets are treated as reasonable in amount for purposes of Section 1397C(b)(2) and Section 1400Z-2(d)(3)(A)(ii), if all of the requirements in Section 1400Z-2(d)(3)(v)(A) through (C) are met.

[10] NQFP includes cash that is not reasonable working capital, cash equivalents, and/or short-term debt (i.e., notes receivable in excess of 18 months). Accounts or notes receivable acquired (seller financing) in the ordinary course of trade or business from the sale of property are not treated as NQFP for purposes of determining whether a QOZB has exceeded this 5% NQFP threshold. Note, however, that if determined to be a sale of property in the ordinary course of business, any gains from such a sale would be treated as gains taxed as ordinary income (i.e., "ordinary gains"), as opposed to gains treated as capital gains eligible for deferral under the Final Regulations (i.e., "eligible gains").

[11] Undesignated cash reserves can be held by the QOZB in amounts up to 5% of unadjusted assets. Amounts exceeding the 5% could be considered excess NQFP, potentially disqualifying the QOZB unless they are designated for use in a written plan as described in the Final Regulations.

[12] As indicated in examples provided in the Final Regulations, the rules would allow a QOZB to string together subsequent or overlapping working capital safe harbors with respect to the same tangible property, as illustrated in the following examples: (a) Example A: a QOZB has master written plan for the completion of a project over a 55-month period, with such plan providing that, in respect of a start-up cash contribution, phase 1 of the project will be completed over a 30-month schedule and upon subsequent receipt of additional equity in cash, phase 2 of the project will be completed over a 25-month schedule; or (b) Example B: a QOZB writes a plan with a 30-month schedule for the use of the Date 1 cash and approximately 18 months after Date 1, on Date 2, such QOZB acquires additional equity in cash and writes a second plan with a 25-month schedule for this cash received on Date 2.

[13] Reg. 1.1400Z2(f)-1.

[14] Reg. 1.1400Z2(d)-2.

[15] 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.

[16] 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% use test, although the application of the rules needs further clarity. 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 a “more than insubstantial” improvement of land.

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

[18] 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 “fair market value 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.

[19] Reg. 1.1400Z2(b)-1.

[20] Reg. 1.1400Z2(b)-1(c)(4).

[21] The Final Regulations also provide that the requirement for property leases to be arm's length does not apply to leases with a state or local government, or an Indian tribal government.

[22] As described in Section 144(c)(6)(B).

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