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Discussion of the Opportunity Zone Program Including Final Regulations

On December 19, 2019, the IRS and Treasury released final regulations under Section 1400Z-2. These final regulations provide final guidance and generally adopt many of the rules that were promulgated in the two sets of proposed regulations that were previously issued. The first set of proposed regulations, issued on October 19, 2018, contained many provisions relating to real property but were confusing and left many questions unanswered. The second set of proposed regulations, released on April 17, 2019, provided more clarity, particularly for businesses (both sets of proposed regulations collectively hereinafter are referred to as “the proposed regulations”). The final regulations generally adopt the proposed regulations previously issued. While some questions remain unanswered, the 544-pages of preamble commentary and regulations provide much needed guidance for investors, fund managers, developers and sponsors. Below is a summary of the qualified opportunity zone (QOZ) program and tax benefits.

OVERVIEW OF THE QOZ PROGRAM

The QOZ program was created through the Tax Reform Reconciliation Act of 2017 (Sections 1400Z-1 and 1400Z-2). The program was designed to encourage long-term investments in economically distressed communities through privatized funding. This was one of the few bi-partisan provisions in the tax reform legislation. There is tax preferential treatment for taxpayers investing in designated opportunity zones through investment vehicles called qualified opportunity funds (QOF). The opportunity zone program expires on December 31, 2026.

The opportunity zones are census tracts that were nominated by the states and approved by Treasury. There are approximately 9,000 opportunity zones that were designated across all 50 states, the District of Columbia and all possessions. Census tracts needed to be in low income communities or contiguous to low-income communities (limited to 5 percent of all nominations). Notice 2018-48 lists the census tracks that were approved by Treasury as opportunity zones. This is a final listing and is essentially unchanging.

TAX BENEFITS

There are three major federal income tax benefits for qualifying investments made in a QOF:

- Tax Deferral – Tax deferral on capital gain invested in QOF to the earlier of an inclusion event or
- December 31, 2026 (at the tax rates existing at that time, not at the time of the investment).
- Tax Reduction – If the investor holds its qualifying investment for five years, the basis of the qualifying investment is increased on the fifth anniversary by 10 percent. Because the program ends on December 31, 2026, investments must be made by December 31, 2021 to obtain this benefit.
- Tax Exemption – If the investment in the fund is held for ten or more years, then the appreciation of the QOF investment (not the original deferred capital gain, but the post-acquisition capital gain) is exempt from taxes. The investment must be sold by December 31, 2047.

CAPITAL GAIN REQUIREMENT

Eligible taxpayers include individuals, C corporations (including RICs/REITs), partnerships, S corporations, trusts, estates, and foreign taxpayers with U.S. capital gains. The triggering event to participate in the opportunity zone program is the realization of short-term or long-term capital gain. The capital gain must be generated from an unrelated party transaction that occurs prior to the QOF investment. Ordinary gains do not qualify. The tax attributes of the initial gain invested into the QOF are preserved.

Capital Gain Deferred

The taxpayer must invest the gross capital gain in a QOF within 180 days of the disposition or sale to a third party. Taxpayers may not invest the capital gain directly into opportunity zone property. All investments must be made through a QOF. The taxpayer will elect to defer the gain on a Form 8949, which must be attached to a timely filed federal income tax return (including extensions) or an applicable amended return.

Either a partnership/S corporation or its partners/shareholders (applicable share) may roll-over capital gain funds into a QOF. For the partnership/S corporation, the 180-day count down starts on the sale date. Partner's/shareholder's 180-day count down, however, start either on the date of sale (if they are notified of the sale); at the end of the pass-through entity's tax year; or on the due date of the entity's tax return (not including extensions). As such, if the pass-through entity has a December 31, 2019, year-end, a partner/shareholder could elect to start the 180-day count down on March 15, 2020, and extend the period for reinvestment into September of 2020. If the partner/shareholder is electing to make the deferral, the gains and losses reported by the pass-through entity will be netted on the Schedule K-1, which may result in a lower benefit than using the gross number at the entity level. Similar rules apply to a decedent's estate.

Sellers who have sold an asset under an installment sale plan will have a series of recurring installment payments, each resulting in a prorated recognition of the capital gain associated with the sale transaction. The guidance provides that the taxpayer may either choose a one-time 180-day window at the end of the seller's tax year (for the year of the sale) to invest the full gain or 180 days after the seller receives each installment check.

The guidance clarified that shareholders in RICs or REITs receive 180 days to invest the capital gain from either the time they receive a capital gain dividend or 180 days from the end of the tax year in which the gain is reported.

QOF investors do not need to defer all their realized capital gain and there is no tracing of the funds. Taxpayers also have the flexibility of investing in more than one QOF. The taxpayer, however, must receive an equity interest of the QOF in return for the investment (e.g., stock, preferred stock, partnership interest with special allocations, etc.). QOFs may have mixed funds, but only the capital gain portion will reap the tax benefits. The QOF may use the equity as collateral for loans. This is particularly beneficial for partners as basis can be increased under the general partnership rules.

The guidance also provided clarity on circular cash flow transactions. To be eligible to obtain the tax benefits under the program, a taxpayer must recognize the capital gain from the sale of property to an unrelated party. There was confusion as to whether a taxpayer would be entitled to the tax benefits if a property was sold to a QOF or a QOZB (an unrelated party) and then the taxpayer invested an amount equal to the capital gain from the sale in the same QOF or QOZB. The final regulations explain that, consistent with general tax principles, a taxpayer's gain from a sale of property to an unrelated QOF or its QOZB is not eligible gain if there was a plan to invest the consideration from the sale back into the QOF that purchased or whose QOZB purchased the property. Any property acquired by the QOF or QOZB in this manner would not be considered as being acquired by purchase and therefore will not qualify as QOZ property.

Section 1231 Gains

There was some uncertainty relating to Section 1231 gains from the sale of business property. Normally, a taxpayer would be required to net all Section 1231 gains with Section 1231 losses to determine if a capital gain existed. This calculation could not be performed until year-end. If a taxpayer generated a Section 1231 gain in February, the investment in the QOF would not be permitted until after December of that year. The new guidance relieved this restriction by permitting a taxpayer to invest Section 1231 gain immediately into a QOF without regard to other Section 1231 losses. Taxpayers no longer need to net the Section 1231 gains and losses. The Section 1231 losses that would have reduced the 1231 gains may now become a Section 1231 ordinary deduction. Also, for investments into a QOF during 2019 or 2020, the requirement to pay tax in 2026 (end of the deferral period) will be outside of the 5-year recapture period.

QOF REQUIREMENTS

QOFs are investment vehicles that are used to invest in opportunity zone property. QOFs are self-certified and can be created by the taxpayer or a taxpayer can invest in an established QOF. The Form 8996 – Qualified Opportunity Fund must be filed with a timely filed return of the QOF for its initial tax year as a QOF. A QOF may be a partnership or a corporation, but it cannot be a disregarded entity - single member LLC or qualified subchapter S-subsidiary. Pre-existing entities can be utilized if they otherwise meet the requirements (including the requirement that substantially all the tangible property was acquired after 2017). One restriction is that a QOF may not invest in another QOF. A QOF, however, may invest in a QOZB of another QOF.

QOF Asset Test

At least 90 percent of the QOF assets must be invested in QOZ property. Newly contributed investments made in the preceding six months are not included as part of the asset ratio if the new assets are being held in cash, cash equivalents or debt instruments with a term of 18 months or less. The 90-percent test is the average of the QOZ property. This test is performed at six months and year-end and reported annually on the Form 8996. The first testing date is at the end of the first six-month period in the QOF's tax year and the second test date is the last day of the tax year. If the QOF is not created until the second half of the tax year, then there will only be one testing date for that year, at year end.

When performing the QOF asset test, there are two methods to value the assets. If the QOF has applicable financial statements (typically audited financial statements), then the value on the statements is used. If there are no applicable financial statements, then the basis of the assets on the date of acquisition is used. Special rules permit the use of the most favorable method for businesses that are owned by multiple QOFs.

Failing to meet the asset test will not result in termination of the QOF. However, a penalty will be assessed equal to the shortfall multiplied by the underpayment rate established under Section 6621(a)(2). While largely undefined, there is reasonable cause relief for failure to pass the QOF asset test.

Qualified Opportunity Zone Property (QOZP)

QOFs can acquire two types of QOZP. The first type is tangible property such as a building or equipment. The second type is the stock or partnership interests in a domestic QOZB.

- The stock must be that of a domestic corporation acquired after December 31, 2017, that is a QOZB during substantially all the holding period.
- The partnership interest must be the capital or profits interest in a domestic partnership acquired after December 31, 2017, this is a QOZB during substantially all the holding period.
- The tangible property must have been acquired from an unrelated party (20 percent common ownership) after December 31, 2017. Substantially all (70 percent) of the tangible property use must be in a QOZ during substantially all (90 percent) of the QOF's holding period.

The IRS was concerned about land banking – purchasing vacant land with no intent to improve the property. The guidance has stated that the general anti-abuse provision can be used to prevent this practice. The IRS, however, did provide some examples that identified modest improvements that it thought would be significant, including adding an irrigation system to farm land and grading land. However, remember that the QOZB must be engaged in an active trade or business under Section 162 for this to qualify.

Original Use

Original use of an asset starts on the date when the property is first placed in service in the QOZ for purposes of depreciation or amortization. Used property is original use if it has not been previously used or placed in service by a taxpayer in the QOZ.

The real property vacancy period to meet the original use test has been reduced from five years to one year if a building was vacant at the time the opportunity zone designations were announced and through the time it was acquired by a QOZ or QOZB. If the building was not vacant at the time of the designation, the vacancy period is three years. Real property is considered vacant if more than 80 percent, as measured by square footage of usable space, is not currently being used.

Leasehold improvements made by a lessee are treated as original use property.

The guidance also provides that all property that is part of a brownfield site (including both land and structures) is considered original use property if, 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. This was done to encourage the clean-up of these sites.

Substantial Improvement

The QOF has "any 30-month" window to improve the acquired QOZ property that does not qualify for original use. The basis of the property must be increased by an amount that exceeds the amount of the adjusted basis with respect to the property (exclusive of land) at the beginning of the 30-month period. The substantial improvement requirement must typically be applied on an asset-by-asset basis, not in the aggregate. There are, however, some exceptions.

Buildings can now be aggregated for purposes of meeting the substantial improvement test if they are on the same or contiguous land. This will assist in helping projects qualify where some buildings do not require rehabilitation while other structures require extensive rehabilitation.

QOFs and QOZBs can now include purchased original use assets that otherwise would qualify as qualified opportunity one business property if the purchased assets are:

- Used in the same trade or business in the QOZ or a contiguous QOZ for which a non-original use asset is used, and
- Improve the functionality of the non-original use assets in the same QOZ or a contiguous QOZ.

The guidance provides that for both QOFs and QOZBs, tangible property that is undergoing improvement pursuant to the substantial improvement process is treated as being used in a QOZ trade or business and satisfies the requirements of the 30-month substantial improvement test. This tangible property will be considered "good" property for purposes of the 90 percent or 70 percent tests (even though the project is not completed) assuming that the QOF and QOZB reasonably expects that the property will be substantially improved and used in a trade or business by the end of the 30-month substantial improvement period.

Revenue Ruling 2018-29 provided clarity with regards to land. The guidance stated that land can never have original use. However, land will not be required to be substantially improved if it is used in an active trade or business. For example, if a real estate investment is made in the amount of $2 million and the building is valued at $1 million and the land at $1 million, then the substantial improvement requirement would be met by investing an addition amount of over $1 million, not $2 million.

Personal property used in an QOZB can be included for purposes of meeting the substantial improvement test, including Section 1245 property. If a QOF purchases an existing opportunity zone business, it will likewise be required to meet the substantial improvement requirement (i.e., doubling the overall adjusted basis of the business' tangible property). If a QOF purchases an existing hotel building for $2 million and land of $1 million, then the QOF could meet the substantial improvement test by purchasing equipment of $1 million (e.g., kitchen appliances, exercise equipment, furniture, bedding and linens, etc.) and spend an addition $1 million plus on structural renovations.

QOZB REQUIREMENTS

QOZBs cross many different industry groups including retail stores, research facilities, hotels, office buildings, manufacturing and mixed-use developments. In order to qualify as a QOZB, the following five requirements must be met:

1. For a subsidiary to qualify, it must be a trade or business for which substantially all (70 percent) of its tangible property (owned or leased) is QOZB property;
2. At least 50 percent of the business's total gross income must be derived from the active conduct of a business in the QOZ;
3. A substantial portion (40 percent) of the business's intangible property is used in the active conduct of the QOZB;

4. Non-qualified financial property must be less than 5 percent of the average of the aggregate unadjusted basis of the business's property (e.g., cash, debt, stock, options, warrants, partnership interest, etc.) - see the working capital safe harbor exception below;
5. "Sin" businesses are prohibited and are defined in the regulations as:
   a. Sun tan parlors
   b. Horse tracks and casinos
   c. Golf courses
   d. Country clubs
   e. Massage parlors
   f. Hot tub facilities, and
   g. Liquor stores (defined as stores with the principal purpose of selling alcoholic beverages for consumption off the premises)

Trade or Business

A trade or business for purposes of the QOZ program is a trade or business within the meaning of Section 162. There is a large amount of case law surrounding Section 162 that will become instrumental in making this determination. The ownership and operation of a real property, including leasing, is considered the active conduct of a trade or business. However, a triple net lease, under the regulations, specifically does not rise to the level of a trade or business. Further, the final regulations do not contain a definition of a triple net lease. Notably, in one example, the lessee was responsible for all the costs related to a leased building. In this example, the triple net lease to a single tenant did not rise to the level of an active trade or business regardless of whether the lessor maintains an office in the leased space to address issues that may arise with the lease. In another example, if a lessor leases a portion of a building on a triple-net basis and other portions under leases that are not triple-net and the lessor maintains an office in the building with employwees who are managing and operating the spaces that are not triple net-leased, this will be considered the active conduct of a trade or business for QOZ purposes.

Gross Income Test

The 50 percent gross income test was a concern to many QOZBs as it could be interpreted to limit the gross income requirement to physical bricks and mortar locations in the opportunity zone. The final regulations relaxed this provision and provided taxpayer-friendly guidance that provides for three safe harbor provisions:

- At least 50 percent of the services performed for the QOZB, measured by hours, is performed within the QOZ.
- At least 50 percent of the services performed by the QOZB, measured by amounts paid for such services, is performed by employees and independent contractors in the QOZ.
- Both the tangible property of the business that is in a QOZ and the management of operational functions performed for the business in the QOZ are necessary to generate 50 percent of the gross income of the QOZB.

If the QOZB does not meet any of these three safe harbors, the guidance states that it may still meet the test by relying on relevant facts and circumstances.

"Sin" Businesses

The sin business restriction only applies at the QOZB level, not at the QOF level. If the business is a "sin" business, then it would be permitted at the QOF level. Cannabis investments in an opportunity zone are still a point of controversy.

The guidance provides that a QOZB that leases more than a de minimis amount of property to a sin business is not a qualified business. Having less than five percent of the assets in a property and gross income of the QOZB can be attributable to a sin business without making it ineligible. This new guidance is beneficial to QOZBs, including grocery stores selling alcohol and hotels with tanning salons.

Cannabis likely would be excluded from the program because it is federally illegal, just as other federally prohibited or controlled substances are not listed. Also, Secretary Mnuchin reportedly advised the Senate to not allow cannabis companies into the program, as he felt it went against the spirit of the opportunity zone program. Careful consideration should be taken when investing in cannabis-related activities as part of a QOF or QOZB.

Intangibles Test

The guidance provides that intangible property will be treated as used in the active conduct of a trade or business in a QOZ 1) if 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.

Working Capital Safe Harbor

The final regulations exclude from the non-qualified financial property limitation a "reasonable" amount of working capital held in cash, cash equivalents, or debt instruments of 18-months or less. Working capital will be considered "reasonable" if:

- The amounts are designated in writing for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone.
- There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets (i.e., cash flow schedule).
- The working capital must be spent within 31 months of receipt by the business.

The working capital safe harbor provisions can be utilized for real estate improvement projects as well as for the development of a trade or business within the QOZ. In addition, the following guidance was provided:

- The working capital safe harbor is not available for QOZ trade or businesses that are invested in and operated directly by a QOF. Only QOZBs are availed this relief.
- Created an additional 62-month safe harbor for start-up businesses to ensure that they can comply with the asset testing standard, the gross income requirement, and the other requirements for QOZBs. This was intended to encourage the use of QOZ investments for start-up businesses that often take a longer time for them to launch.
- A QOZB can receive an additional 24 months to use working capital if the QOZB is in a federally-declared disaster zone.
- Clarified that the safe harbor can only be used for a 62-month period and that amounts remaining at the conclusion of the period cannot be counted as tangible property for purposes of the 70 percent tangible property standards.
- Allows tangible property that is being improved to qualify as being used in the QOZB's trade or business for purposes of the requirement that a QOZB must be engaged in a trade or business.
- A QOZB not utilizing the safe harbor may treat tangible property undergoing the substantial improvement process as being used in a trade or business.
- There also is a provision that states that the working capital safe harbor will not be violated if the delay is due to a government action (e.g., permits or other government approvals are delayed).

Leased Tangible Property

Leased tangible property may be treated as QOZ property for purposes of the 90 percent and 70 percent QOF and QOZB asset tests. The leased property must be acquired under a lease that is entered into after December 31, 2017. Substantially all the use of the leased property must be in a QOZ during substantially all the period for which the QOF or QOZB leases the property. There is no original use requirement for leases.

The related party (20 percent common ownership) disallowance rule will not apply if the lease meets the following requirements:

- Lease must be at fair market value.
  - There is a rebuttable presumption that leases between unrelated parties are market-rate and allow for leases with state and local governments and Indian tribal governments that are not market rate.
  - Leases that are not between related parties are presumed to be at market rate.
- Lease cannot allow prepayments relating to a period of use exceeding 12 months.
- For personal property, by the last day of the lease or 30 months (whichever comes first), the lessee must become the owner of the QOZB property whose value is at least equal to the value of the lease and there must be substantial overlap of time using both the leased and acquired property.
- There is a general anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement.
- Short-term leases of personal property to lessors using the property outside a QOZ may be counted as QOZB property.

There are two methods for valuing leases. The first method is valuing the lease amount pursuant to the GAAP financial statement. The second method is the alternative method, which is the sum of the present value of all the lease payments calculated at the time the lease is executed. Once a method is selected, it must be applied consistently to all leased tangible property for the taxable year.

Inventory

Normally inventory would be considered an asset that should be included in the QOZ asset testing. However, the tracking of the inventory for this purpose could be onerous. Thus, the final regulations permit for purposes of both the 90 percent asset test at the QOF level and the 70 percent tangible property test at the QOZB level to either totally exclude inventory from the asset tests (both numerator and denominator) or include inventory, but carve it out entirely while in transit or temporarily in a warehouse facility outside the opportunity zone, as long as it is applied consistently for the taxable year.

Straddled Property

If real property straddles a QOZ, then either a square footage test or an unadjusted cost test can be used to determine if the property is within the zone for purposes of determining whether real property outside a QOZ qualifies as QOZ property, the requirement to use a substantial portion of intangible property in the QOZ, and the requirement to derive 50 percent of gross income from the active conduct of a business in the QOZ. Each QOZB may use only the square footage test or the unadjusted cost test consistently throughout the holding period for any given grouping of contiguous real property.

EXIT STRATEGY

The proposed regulations issued in April 2019 required either a sale of the assets at the QOF level or the sale of the taxpayer's interest in the QOF in order to take advantage of the 10-year hold capital gain exclusion. The final regulations provide that the QOF investors in a QOF partnership or a QOF S corporation that has held their qualifying investment in the QOF for at least 10 years can elect to exclude all capital gain (other than gain from the sale of inventory in the ordinary course of business) on the sale of property by a QOF or a QOZB. Based on the guidance, there will be no recapture of depreciation. The final regulations provide for additional computational guidance for calculating the basis step-up for sales of partnership interest, including the use of corresponding adjustment to the assets of the partnership. This provision does not apply to C corporations.

If a QOZ, QOZB or investor sells an asset before the 10-year holding period, there is a 12-month safe harbor to reinvest the cash. The final regulations did not include a provision that would allow the sale and reinvestment of assets to not be recognized. Therefore, a sale before the 10-year holding period is met will be a taxable event.

OTHER TAX CONSIDERATIONS

In addition to the tax incentives, there are other tax considerations that should be considered, including the following:

- If a taxpayer dies, the capital gain will still be recognized on the original investment (deferred until an inclusion event or 2026, whichever is later). There is no step-up at the date of death.
- The transfer of a QOZ interest by gift is an inclusion event, but the transfer at death or to a grantor trust is not an inclusion event.
- Carried interest does not receive the tax incentives under the program.
- The capital gains rate is the rate that is applicable when recognized, not the date of the investment into the QOF.
- A C corporation QOF may now be treated as a member of the consolidated corporate group.
- Final regulations provided additional guidance for corporate consolidated groups.
- The tax benefits of the opportunity zone program may be able to be combined with other federal tax credits including low income housing, new markets credit, and historic tax credits.
- The tax benefits of the opportunity zones program may be combined with other state and local tax incentive programs.
- If the value of the investment decreases, then the taxpayer is taxed at the lower value (excess of fair market value in the QOF over the taxpayer's basis in the QOF interest).
- The secondary purchase of a QOF interest is permitted.
- The final regulations provided additional clarification around inclusion events (i.e., termination of a qualified investment and the related capital gain deferral).
- Procedures for a QOF to voluntarily decertify itself.
- Provides a single-use six-month opportunity for QOZBs to cure deficiencies.
- Consider tax implications of exit strategies and other structuring issues.
- The final regulations provide broad anti-abuse rules that should not be ignored. The IRS is permitted to interpret a transaction or series of transactions and the establishment and operation of a QOZB as necessary to achieve the goals of the opportunity zone program and to present tax results that are inconsistent with the goals and spirit of the program, based on all the relevant facts and circumstances.

- Treasury and the IRS announced that additional guidance will be provided regarding a QOF that fails to meet the required 90 percent asset testing and information reporting requirements.

EFFECTIVE DATE

The final regulations apply to any taxable year that begins more than 60 days after the final regulations are officially published in the Federal Register. In the case of a calendar year taxpayer, the final regulations apply on or after January 1, 2020. For years prior to 2020, the taxpayer may choose to apply all the final regulations, rely on all the proposed regulations, or rely on the plain meaning of Section 1400Z-2.

CONCLUSION

The final regulations provided some taxpayer friendly changes for the opportunity zone program and may be instrumental in bolstering investor and sponsor confidence in the QOZ concept. While the proposed regulations did not answer every question, it is clear from the guidance that the government is trying to incentivize investment in the QOZs by easing the tests and providing flexibility to potential developers, operators and investors.

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