

On December 19, 2019, the U.S. Treasury Department and the IRS issued final regulations implementing the Opportunity Zones tax incentive. The final rules (once we have a chance to read them) according to the IRS press release, seek to provide clarity for Opportunity Funds and their eligible subsidiaries in determining qualification and levels of new investment in Opportunity Zones. They also provide guidance regarding the types of gains that qualify for Opportunity Zone investments, as well as gains that may be excluded from tax after a 10-year holding period. Per the IRS's FAQs on the final regulations:

What types of gains may be invested and when?

- *General rule* — The final regulations amend the proposed regulations' general rule that only capital gain may be invested in a Qualified Opportunity Fund (QOF) during the 180-day investment period by clarifying that only eligible gain taxable in the United States may be invested in a QOF.
- *Sales of business property* — The proposed regulations only permitted the amount of an investor's gains from the sale of business property that were greater than the investor's losses from such sales to be invested in QOFs, and required the 180-day investment period to begin on the last day of the investor's tax year. The final regulations allow a taxpayer to invest the entire amount of gains from such sales without regard to losses and change the beginning of the investment period from the end of the year to the date of the sale of each asset.
- *Partnership gain* — Partners in a partnership, shareholders of an S corporation, and beneficiaries of estates and non-grantor trusts have the option to start the 180-day investment period on the due date of the entity's tax return, not including any extensions. This change addresses taxpayer concerns about potentially missing investment opportunities due to an owner of a business entity receiving a late Schedule K-1 (or other form) from the entity.
- *Investment of Regulated Investment Company (RIC) and Real Estate Investment Trust (REIT) gains* — The rules clarify that the 180-day investment period generally starts at the close of the shareholder's tax year and provides that gains can, at the shareholder's option, also be invested based on the 180-day investment period starting when the shareholder receives capital gains dividends from a RIC or REIT.
- *Installment sales* — The rules clarify that gains from installment sales are able to be invested when received, even if the initial installment payment was made before 2018.

- *Nonresident investment* — The final regulations provide that nonresident alien individuals and foreign corporations may make Opportunity Zone investments with capital gains that are effectively connected to a U.S. trade or business. This includes capital gains on real estate assets taxed to nonresident alien individuals and foreign corporations under the Foreign Investment in Real Property Tax Act rules.

When may gains be excluded from tax after an investment is held for a 10-year period?

- *Sales of property by a Qualified Opportunity Zone Business (QOZB)* — In the proposed regulations, an investor could only elect to exclude gains from the sale of qualifying investments or property sold by a QOF operating in partnership or S Corporation form, but not property sold by a subsidiary entity. The final regulations provide that capital gains from the sale of property by a QOZB that is held by such a QOF may also be excluded from income as long as the investor’s qualifying investment in the QOF has been held for 10 years. However, the amount of gain from such a QOF’s or its QOZBs’ asset sales that an investor in the QOF may elect to exclude each year will reduce the amount of the investor’s interest in the QOF that remains a qualifying investment.
- *Applicability to other gains* — The final rules clarify that the exclusion is available to other gains, such as distributions by a corporation to shareholders or a partnership to a partner, that are treated as gains from the sale or exchange of property (other than inventory) for Federal income tax purposes.

How does a Fund determine levels of new investment in a Qualified Opportunity Zone?

- *Aggregation of property for purposes of the substantial improvement test* — QOFs and QOZBs can take into account purchased original use assets that otherwise would qualify as qualified opportunity zone business property if the purchased assets:
 - Are used in the same trade or business in the Qualified Opportunity Zone (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.
- *Aggregation of property for purposes of the substantial improvement test (continued)* — In certain cases, the final regulations permit a group of two or more buildings located on the same parcel(s) of land to be treated as a single property. In these cases, any additions to the basis of the buildings in the group are aggregated to determine satisfaction of the substantial improvement requirement. Thus, a taxpayer need not increase the basis of each building by 100% as long as the total additions to basis for the group of buildings equals 100% of the initial basis for the group.
- *Vacancy period to allow a building to qualify as original use* — The final regulations reduce the five-year vacancy requirement in the proposed regulations to a one-year vacancy requirement, if the property was vacant for at least one-year prior to the QOZ

being designated and remains vacant through the date of purchase. For other vacant property, the proposed five-year vacancy requirement is reduced to three years. In addition, property involuntarily transferred to local government control is included in the definition of the term vacant, allowing it to be treated as original use property when purchased by a QOF or QOZB from the local government.

- *Leasing* — The final regulations provide several changes to leasing provisions in the proposed regulations:
 - State and local governments, as well as Indian tribal governments, will be exempt from the market-rate requirements for leased tangible property,
 - Leases between unrelated parties are generally presumed to be at market rate terms, and
 - Short-term leases of personal property to lessors using the property outside a QOZ may be counted as Qualified Opportunity Zone Business Property (QOZBP).
- *Working capital safe harbor* — The final regulations provide several refinements to the working capital safe harbor:
 - They create an additional 62-month safe harbor for start-up businesses to ensure that they can comply with the 70-percent tangible property standard, the 50-percent gross income requirement, and other requirements to qualify as a QOZB;
 - They provide that a QOZB can receive an extra 24 months to use working capital if the QOZ is in a Federally-declared disaster area;
 - They clarify 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 standard; and
 - They allow a QOZB to treat equipment, buildings, and other tangible property that is being improved with the working capital as QOZBP that is “used in a trade or business” for purposes of the requirement that a QOZB must be engaged in a trade or business.
 - In addition, the final regulations provide that a QOZB not utilizing the working capital safe harbor may treat tangible property undergoing the substantial improvement process as being used in a trade or business.
- *Measurement of “use” for the 70-percent use test*— The final regulations provide that, if tangible property is used in one or more QOZs, satisfaction of the 70-percent use test is

determined by aggregating the number of days the tangible property in each QOZ is utilized. Accordingly, the final regulations set forth a clearer way for determining satisfaction of the 70-percent use test, including a safe harbor for certain tangible property used both inside and outside the geographic borders of a QOZ.

- *Determinations of location and “use” of intangible property* — The final regulations provide that intangible property qualifies as used in the QOZ if:
 - The use of the intangible property is normal, usual, or customary in the conduct of the trade or business, and
 - The use contributes to the generation of gross income for the trade or business.
- *Other clarifications regarding business property of QOFs or QOZBs* —
 - *Real property straddling census tracts* — 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-percent use test.
 - *Brownfield sites* — The final regulations provide that both the land and structures in a Brownfield site redevelopment are considered to be original use property as long as the QOF or QOZB make investments into the Brownfield site to improve its safety and compliance with environmental standards.
 - *Self-constructed property* — The final rules provide that self-constructed property can count for purposes of the QOF’s 90-percent asset test and the QOZB’s 70-percent asset test, and is valued at the purchase price as of the date when physical work of a significant nature begins.
 - *De minimis exception for “sin businesses”* — The final regulations provide that a QOZB may have less than 5 percent of its property leased to a so-called “sin business” described in 26 U.S.C. §144(c)(6)(B). For example, a hotel business of a QOZB could potentially lease space to a spa that provides tanning services.

Our team looks forward to diving into the minutiae and will be issuing further white papers over the coming days. In the meanwhile, please do not hesitate to call with any questions or comments.