Treasury releases final opportunity zone regulations

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12/20/2019

As we wrap up 2019, we received final opportunity zone regulations – two years almost to the day of the original statute. This marks the end of the beginning of this critical but exhaustive process. We applaud the Treasury, and while we didn't get every change we wanted, clearly this will be supportive of advancing investment activity in opportunity zones. We do have clarity, and most importantly, we have finality. Not withstanding the end of this regulatory process, the public and private sector will continue to cooperate and produce additional guidance.

We have highlighted below what we consider the most important elements of this comprehensive package. We will continue to review this material in the days, weeks, and months ahead and look forward to digging into the technical nuance and the practical outcomes for the benefit of low-income communities that are opportunity zones.

Section 1231 gains

In a departure from the proposed regulations, the final regulations allow for investment of gross Section 1231 gains, not just the net gain. Additionally, they say that the 180-day period for investment of a Section 1231 gain for which a deferral election is made begins on the date of the sale or exchange that gives rise to the gain, not the end of the taxpayer's year-end.

Original use of tangible property and substantial improvement test

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 a) was vacant for at least one year prior to the qualified opportunity zones (QOZ) being designated and b) remains vacant through the date of purchase. For vacant property that does not meet these two requirements, the proposed five-year vacancy requirement is reduced to three years. 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 qualified opportunity fund (QOF) or qualified opportunity zone business (QOZB) from the local government. Real property, including land and buildings, is considered vacant if more than 80% of the building or land is not currently being used.

Brownfield sites. Final regulations provide that all real property composing a brownfield site, including land and structures located thereon, will be treated as satisfying the original use requirement. Final regulations clarify that remediation of contaminated land is taken into account for determining if the land has been more than minimally improved, and that the QOF or QOZB must make investments into the brownfield site to improve its safety and environmental standards.

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 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.

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.

Treatment of debt

The proposed and now final regulations state that an eligible interest is defined as an equity interest in the QOF and not a debt interest. One area of clarification is where an eligible taxpayer lends money to the QOF and later converts it to equity position after the sale of eligible gains. The determination of whether this results in an eligible interest requires a debt-equity analysis, and the IRS determined that such analysis would be outside the scope of the regulations.

Another fact pattern clarified is in a situation where an eligible investor is issued an interest in the QOF in exchange for a promissory note to the QOF. The IRS stated that the transaction again is outside the scope of the regulations but did say that a contribution of a promissory note should not be treated as “cash or property.”

Inclusion events

The final regulations retain the general rules from the proposed regulations governing events that trigger the inclusion of deferred gain, but clarify several aspects in response to comments.

The final regulations clarify or adopt the following:

- If a QOF is decertified, either voluntarily or involuntarily, such decertification is an inclusion event. The final regulations also clarify that a transfer between spouses or incident to divorce as described in Section 1041 is an inclusion event.

- Gain arising from an inclusion event is eligible for deferral even though the taxpayer retains a portion of its qualifying investment after the inclusion event.

- Qualifying investments that have been subject to inclusion events should continue to be eligible for the five-year and seven-year basis increases to the extent deferred gain has not yet been recognized at the time of these basis increases.

- Remove the proposed rule that an S corporation’s qualifying investment in a QOF would be treated as disposed if there is a greater than 25% aggregate change in ownership of the S corporation.

- For amounts relating to a partner’s qualifying investment, a distribution by a QOF partnership to a partner is an inclusion event to the extent the distribution is of cash or property with a fair market value in excess of the partner’s outside basis in the QOF partnership. However, with respect to distributions by a partnership that owns a QOF, such distribution will only be an inclusion event for the indirect QOF owner if the distribution is a liquidating distribution.

Leases

Leased tangible property as QOZBP. A lease between unrelated parties is presumed to be a market rate lease. Property leased from state, local, and Indian tribal governments is exempt from the requirement that the lease be at market rate. This exemption makes it easier for governmental entities to incentivize businesses in their opportunity zones. Leased assets are included in the determination of qualified opportunity zones business property (QOZBP) at the present value of the lease calculated by discounting each payment under the lease using the short-term Applicable Federal Rate (AFR).

Triple-net leases. The final regulations confirm that leasing a building on a triple-net-lease basis *does not* meet the requirement for active conduct of a trade or business for purposes of the definition of a QOZB. A multi-lease building where only some of the leases are on a triple net basis may qualify as an active trade or business. Ultimately, the determination comes down to facts and circumstances. Essentially, the more building management and operational responsibilities the lessor's employees have, the better.

Working capital Safe Harbor

Start-up businesses that expect multiple cash infusions now may qualify for an extended working capital safe harbor period. The final rules clarify that each cash infusion must meet the 31-month safe harbor requirement, and the total safe harbor period cannot exceed 62 months from the initial contribution. Examples illustrate the operation of this provision with respect to several types of businesses.

50% gross income requirement

A QOZB must derive at least 50% of the total gross income of the entity from the active conduct of a trade or business. The final regulations clarify that the income can be generated in multiple QOZs.

90% investment standard

This provision is a bedrock of compliance for a QOF, but little changed in the final regulations. Some helpful safe harbor provisions were established to make it clear that inventory would not count against the calculation (and the 70% tangible property standard, as well) and that inconsistent tax years between the QOF and QOZB would not either.

A six-month cure period for failure to qualify was incorporated, prior to a penalty being incurred, although the actual penalty determination will be the subject of future guidance. No wind-down provision was incorporated to ease the challenge of maintaining the 90% as assets were disposed of.

Capital gains tax rate

The final regulations affirmed this tax rate will now be calculated at the end of the year the asset is disposed of from the QOF, and not the year that the capital gains were deferred into the QOF.

Multi-asset OZ funds

The final regulations allow more flexible exits from multi-asset OZ funds, including avoidance of depreciation capture. After an investor has held an OZ Fund investment for at least 10 years, there will be no taxes on any gains or losses from the sale of property or depreciation recapture at both the QOF-level and at the QOZB-level that is held by the QOF (except for gains or losses from inventory sales). This treatment also applies to distributions by a corporation or a partnership that are treated as capital gains.

Consolidation/deconsolidation

Many commenters requested that QOF C corporation subsidiaries be permitted to join in the filing of consolidated income tax returns. Commenters also requested rules detailing the consequences of deconsolidation provided the Treasury and IRS declined to allow QOF subsidiaries to remain in the group.

The final regulations permit QOF C corporation subsidiaries to be included in consolidated income tax returns provided certain requirements are met. These requirements include:

- The group member that makes the qualifying investment in the QOF subsidiary must maintain a direct equity interest in that QOF subsidiary.

- The QOF investor corporation must be wholly owned, directly or indirectly, by the common parent of the consolidated group.

The final regulations also provide rules regarding the deconsolidation of QOF subsidiaries that are ineligible for consolidation. Specifically, the deconsolidation is treated as a disposition for the purposes of Section 1.1502-19. As such, any excess loss account for the QOF subsidiary that is deconsolidated will be included in income. This deconsolidation will be considered an inclusion event only to the extent that the deconsolidation event itself constitutes an inclusion event.

REITs

For purposes of the 180-day period rule, the proposed regulations provided that the 180-day period began on the day the shareholder received the REIT dividend. This presents problems, however, in that REIT capital gain dividends are based on the net capital gain of the REIT for the entire year. As such, a REIT cannot determine the amount of the dividend eligible as capital gain until its year-end, and so the REIT shareholders will not know if the dividend received was a capital gain dividend until the REIT's year-end.

The final regulations provide that the 180-day period for a REIT capital gain dividend generally begins at the close of the shareholder's year in which the dividend is received. Alternatively, a shareholder may elect to begin the 180-day period on the day the capital gain dividend is received after it is designated as such.

Anti-abuse provision

There were many anti-abuse provision considerations requested, but much of those specifics were not incorporated in the final regulations. Generally, the final regulations sustained the principle that a significant purpose of a transaction cannot be to achieve a tax result inconsistent with the statute itself.

There are seven specific examples included that identify fact patterns that would render a transaction qualified or disqualified as each case's facts and circumstances may be. There is no "good faith exception" to any action.

Certification and reporting

The QOF self-certification did not change in the final regulations, despite efforts to increase oversight of this process based on the concern that more layers to the certification would curtail investment.

However, there is a provision to permit a QOF to self-decertify effective the month following the month specified by the taxpayer. Additional instructions are forthcoming, as is guidance as to what would constitute involuntary decertification, and a rule is also included that makes either form of decertification an inclusion event.

Comments related to reporting of the QOF and its investments were voluminous, but ultimately nothing was adopted, as the draft forms are expected to address the data requirements. It is also likely that the IMPACT Act or some similar legislation will take up this issue in greater detail.

For an initial comprehensive, in-depth analysis of the proposed regulations, including what has and hasn't changed, watch for our January Tax Alert newsletter and upcoming webinar.

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