Final Opportunity Zone Treasury Regulations Released

Description

By Russell J. Stein

On Thursday, December 19th, the U.S. Department of Treasury released the long-awaited final Opportunity Zone Treasury Regulations (the “Final Regulations”). The Final Regulations and explanatory materials that span 544 pages, are quite extensive and give some needed clarity into how the Opportunity Zone tax rules work. This client alert is intended to highlight just some of the changes and clarifications in the rules.

As a brief refresher, the Tax Cuts and Jobs Act signed into law in 2017 created a tax incentive aimed at increasing economic development in low-income communities. Generally under the law, Opportunity Zones provide three potential tax savings opportunities for investors (assuming a timely election is made on their tax return and other eligibility requirements are met): 1) deferral of recognition of capital gain if such gain is invested in a Qualified Opportunity Fund (a QOF) within a specified 180-day period, 2) exclusion of up to 15 percent of the deferred gain from taxation (assuming an eligible investment in a QOF is made by December 31, 2019, and held for at least 7 years), and 3) exclusion from taxation on any appreciation in the QOF if the investment is held for at least 10 years prior to sale.

Treasury has issued two prior sets of proposed regulations. The Final Regulations consolidate these proposed regulations as well as change various parts to reflect comments received on the rules over the last two years. Among the changes that were made, the Final Regulations clarify aspects of the 180-day investment period, clarify how the substantial improvement test is met, changed the rules relating to the purchase and development of vacant property, expanded the working capital safe harbor for start-up businesses, and provided a de minimis exception for “sin” businesses.

1. Clarification on when the 180-day investing period starts.

o For business property (i.e., section 1231 gain), the proposed regulations stated that the 180-day period for investing 1231 gain in a QOF started on the last day of the year regardless of when the property was sold. The Final Regulations provide that the 180-day period for investing eligible 1231 gains begins on the date of the sale or exchange, not on December 31st, allowing more flexibility to invest capital gain relating to the sale of business property.

o Partners in a partnership, shareholders of an S corporation, and beneficiaries of estates and non-grantor trusts now have the option to start the 180-day period on the due date of the applicable entity’s tax return (not counting any extension) instead of on the last day of the entity’s taxable year. For such “pass-through” investors, this allows a little more time to start the 180-day investing period.

o Under the Final Regulations, gain from installment sales are eligible to be invested when received not just when the original transaction occurred that created the installment sale.
2. More flexibility in the determination of whether the “substantial improvement test” is met. The proposed regulations appeared to utilize an asset by asset approach in determining whether the substantial improvement test was met, each asset had to be individually improved under that test. Under certain situations, the Final Regulations allow the aggregation of buildings within a zone or contiguous zones to be treated as a single property to determine if the test is met, possibly allowing the improvements on one property to satisfy the substantial improvement test for multiple properties.

3. Vacant property rules changed. Property vacant for at least 3 years prior to purchase by a QOF (or at least 1 year if the property was vacant before the zone was designated as such and remained vacant upon the

purchase) can now qualify as original use property and won't be required to meet the substantial improvement test.

4. The Working Capital Safe Harbor is extended for start-up businesses. The Final Regulations provide that the 31-month Working Capital Safe Harbor could be applied more than once in the same start-up business, allowing for multiple cash infusions in a business for up to 62 months if the requirements are met. This could allow start-up entities to hold onto cash without violating the five percent limitation on holding "nonqualified financial assets" if the requirements are met.

5. De minimis exception for "sin businesses" added. A qualified opportunity zone business (a QOZB) must be involved in an active trade or business in order to be an eligible investment. Certain "sin" businesses (such as liquor stores or spas) are excluded from the definition of a permitted active trade or business. The Final Regulations allow a QOZB to have less than five percent of its property leased to a "sin" business and still qualify as an active trade or business. This carve-out could help businesses such as hotels lease a portion of their property to a spa and still qualify as a QOZB.

It is important to note that the deadlines under the program have not changed. In order to be eligible for the full 15 percent exclusion from income of the deferred capital gains, an investment in a QOF must be made by **December 31, 2019**, next week! After such time, the exclusion drops to 10 percent provided the investment is held for at least five years prior to December 31, 2026.

This is just a highlight of some of the items in the Final Regulations. Along with the additional guidance, they are quite extensive and include changes to many other provisions, including what constitutes "inclusion events," how to treat the transferring of interests due to death or gift, and how to address property that straddles between an opportunity zone and a non-opportunity zone. The Final Regulations did leave some questions left unanswered — such as, when can the IRS involuntarily "decertify" a QOF? — and decided not to change some other aspects of the rules — such as the prohibition of "triple-net leases" in the active trade or business requirement.

It will take some time to fully review the Final Regulations, and the application of the rules to any particular investment or business vary depending on the specific facts involved. As with many tax regulations, a "foot fault" can invalidate any tax benefits, so it is important to plan ahead when contemplating setting up or investing in a Qualified Opportunity Fund.

If you need help understanding Opportunity Zones, or if you would like to discuss ways to establish or invest in a Qualified Opportunity Fund, please contact Russell J. Stein at Partridge Snow & Hahn LLP.

See previous Opportunity Zone alerts authored by Russell Stein:

Massachusetts Tax Alert, June 2019
IRS Issues Additional Regulations Providing More Clarity To Opportunity Zone Investments, May 2019
Qualified Opportunity Funds: Ten Issues to Keep in Mind, January 2019
Southcoast Opportunity Zones Provide Opportunities for Investors To Defer And Possibly Exclude Capital Gains From Federal Income Taxation, September 2018
New Federal Tax Incentive Provides Opportunities to Defer Gains, as seen in *Banker & Tradesman* August 2018

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