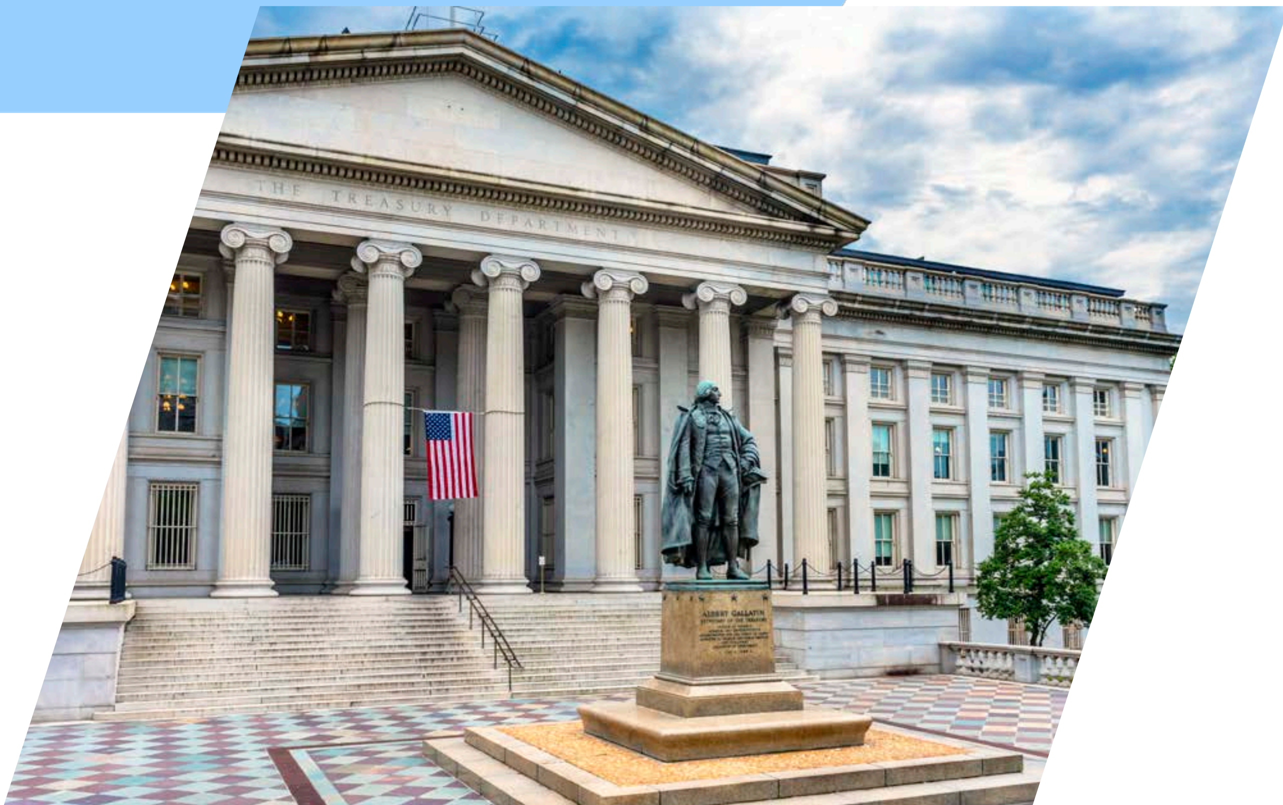
DUVAL & STACHENFELD LLP

The Final Opportunity Zone Regulations – Coasting to the Finish Line



D&S Opportunity Zone Practice Group
December 2019

The Final Opportunity Zone Regulations

In a big year-end push, Treasury released final regulations (the "Final Regulations") on the Opportunity Zone program (the "OZ Program") on December 19, 2019. With remarkably few exceptions, the Final Regulations are extremely taxpayer friendly, adding much needed clarity to certain critical issues and significant flexibility to previously inflexible structuring rules.

The Final Regulations combined guidance previously issued in two separate packages of proposed regulations in October 2018 and April 2019 (collectively, the "Proposed Regulations"). While a few issues are still reserved for future guidance, we now have the bulk of our questions answered.

Keep in mind that the final regulation package was over 500 pages, so this summary provides only a high level overview of the critical issues that the real estate community needs to know, but of course there is much more under the hood! Read on for the highlights, and then contact the D&S Opportunity Zone team for a deeper dive. We are assuming some familiarity with the OZ Program. If you are new to the Land of OZ, or need a refresher on some of the basics, our full set of white papers can be found here.

I- Get on the bus – Investor issues

Starting from the top, here are the big takeaways for anyone investing into a qualified opportunity fund ("QOF").

a. Your exit is coming up – The 10-year tax benefit is available for asset sales

Of the 3 tax benefits available to QOF investors, the 10-year tax benefit is the brass ring. If an investor holds its QOF interest for at least 10 years, there is no federal income tax on the gain realized by the investor at exit.

The 10-year tax benefit as drafted in the Internal Revenue Code (the "Code") seemed to require an investor to sell its QOF equity interest, which made structuring a multi-asset fund fairly difficult.[1] The Proposed Regulations added some flexibility by permitting investors to exclude capital gain allocated to them from sales by the QOF of qualifying property. However, since most QOFs are set up under the two-tier structure, where a QOF owns equity in a partnership or corporation subsidiary qualifying as a qualified opportunity zone business ("QOZB"), an exit via property sale by the QOZB would not have allowed an investor to elect the 10-year tax benefit under prior guidance.

[1] If a QOF is also set up as a REIT, a commingled fund was possible under prior guidance because investors were still able to get the 10-year tax benefit on property sales. But if a QOF is set up as a partnership for tax purposes, prior guidance did not permit investors to elect the 10-year tax benefit on property sales.

The Final Regulations finally break this logjam and permit investors to elect the 10-year tax benefit on any gain allocated to them from a sale or exchange of property by either the QOF or the QOZB, other than gain from the sale of inventory property. In addition to facilitating a multi-asset fund, this will simplify previously complex exit provisions required for entity sales. This is probably the biggest takeaway from the Final Regulations, and we expect that this could open up the market for new OZ Program deals.

b. Hurry up and wait no longer – Section 1231 gains

The Proposed Regulations limited investments of Section 1231 gains (i.e., gains from the sale of real property used in a business) to "net" Section 1231 gains, which required an investor to net its Section 1231 losses against its Section 1231 gains as of the last day of its taxable year.

The Final Regulations welcome Section 1231 gains fully into the QOF fold by permitting an investor to invest gross Section 1231 gains as eligible gain into a QOF.

Additionally, Section 1231 gains are now subject to the same timing rules as other capital gains, so an investor no longer needs to wait until the end of the year to determine its eligible Section 1231 gains. The only qualification is that the gain cannot be recapture gain arising from personal property that would be treated as ordinary income.

c. Any road will get you there – More options for K-1 gains

If a partnership sells an asset to generate an eligible gain, the partnership can invest in a QOF. If the partnership does not invest in a QOF, any partner can invest its share of the eligible gains. Those partners now have three choices for their 180-day period to invest in a QOF: (i) the 180-day period beginning on the date the asset is sold, (ii) the 180-day period beginning on the last day of the partnership's taxable year (generally December 31st), or (iii) the 180-day period beginning on the date the partnership's tax return is due, without extensions (generally March 15th).

This last option was newly added in the Final Regulations, and it addresses the (very common) concern that most partners do not receive their K-1s for a taxable year until spring, or even summer, of the following year. So the new 180-day window aligns nicely with the full amount of time that other QOF investors have to decide whether to invest in a QOF.

The Final Regulations include a requirement that partnerships notify their partners if the partnership invests eligible gain into a QOF, so partners can know whether they have the ability to invest their K-1 gain.

d. You can wait for certainty – REIT capital gain dividends

REIT shareholders were also included in Treasury's practical interpretation of the timing rules for QOF investments. Since REIT capital gain dividends are based on the net capital gain of the REIT for a taxable year, and since some shareholders may have a different taxable year than the REIT, the 180-day reinvestment period for REIT capital gain dividends under the Final Regulations begins on the last day of the shareholder's taxable year in which the capital gain dividend would otherwise be taxed.

Alternatively, a REIT shareholder can elect to use the 180-day period beginning on the date of the dividend distribution. Since the total amount of capital gain dividends that can be reinvested by a REIT shareholder as eligible gain is capped at the total amount of capital gain dividends reported or designated by the REIT for that shareholder for the taxable year, it is only wise to do this if you know for sure that the REIT will declare that amount of capital gain dividends for the year.

e. If you take a wrong turn, get back on the road – Inclusion events can generate eligible gain

If you have an inclusion event before the end of 2026, either from a full disposition of your QOF interest or just a partial one (such as a distribution in excess of basis), you can reinvest the inclusion gain as eligible gain. Your 180-day period to reinvest starts on the date of the inclusion event, and your holding period begins on the date you reinvest into a QOF, but at least you can get back in the game.

II- 90% or bust – QOF Issues

The Final Regulations helpfully clarify a few of the issues that QOFs need to worry about.

a. Merging lanes ahead – QOF mergers are okay

Under previous guidance, you had to be really sure about your QOF structure on Day 1, since it was difficult to restructure a QOF after initial investments were made. Under the Final Regulations, however, a QOF partnership can merge with another QOF partnership without triggering an inclusion event for their investors (as long as no other distributions are made in connection with the merger).

However, there is no such relief for partnership divisions, so you cannot split up your QOF partnership as easily. With the new flexibility on exit and the ability to elect the 10-year benefit on asset sales, partnership divisions are less critical now.

b. Hold on tight – Measuring QOZB status for the holding period test

Since most QOFs are set up with the two-tier structure, most QOFs will pass their 90% asset test by owning qualifying equity in a QOZB. Equity in a QOZB is only a qualifying asset for a QOF if the QOZB is a good QOZB for at least 90% of the QOF's holding period of that equity.

No one really knew how to measure this holding period test, so it was helpful to finally get some clarity from Treasury. The Final Regulations clarify that the holding period test must be met on a cumulative basis from the time the QOF acquires equity in a QOZB until the relevant testing date. You cannot rely on future expected status to meet the holding period test and you cannot measure compliance with the holding period test only at the end of an investment.

A QOF measures the QOZB's compliance as a good QOZB on a semi-annual basis on the QOF's two required testing dates each year (generally June 30th and December 31st). However, since a QOZB's own testing is typically going to be measured on an annual basis, the Final Regulations permit a QOF to measure compliance with the holding period test on the June 30th testing date by looking solely to the holding period as if it ended at the end of the QOZB's previous taxable year. For example, on the June 30th testing date in Year 3, the QOF can measure compliance with the holding period test through the end of Year 2, since the QOZB's own Year 3 testing is not technically complete until the end of Year 3.

A QOF has one chance during its lifetime to cure a bad QOZB test for purposes of its 90% holding period requirement. If a QOZB is not a good QOZB on a particular testing date, the QOF can treat the QOZB as being a good QOZB as long as the QOZB cures its failure within 6 months. For example, if a QOZB fails to meet one of its tests on the December 31st testing date in Year 3, the QOF can treat the QOZB as having been in compliance on December 31st of Year 3 if the failure is cured by June 30th of Year 4. The QOF will have to file for an extension to file its Year 3 tax return in this instance.

c. End of the road – QOF decertification

Treasury first hinted at decertification of a QOF in the first round of Proposed Regulations and unfortunately this is one of the few areas that is still reserved for future guidance. We did find out that a QOF can voluntarily decertify, but involuntary decertification is still under review. Treasury

similarly punted on any further guidance related to the penalty for a QOF's failure to meet the 90% asset test, so this is another one that will require follow up.

If a QOF is decertified, the decertification will be an inclusion event for investors. If this occurs, remember that an investor can reinvest the resulting gain from an inclusion event within 180 days, as long as the inclusion event occurs before the end of 2026.

III- No sleep till… the Land of OZ – QOZB Issues

Since QOZB compliance is likely to be at the heart of most QOF deals, the guidance for QOZBs in the Final Regulations is particularly welcome.

a. Crashing it all together – QOZB mergers okay

QOZBs were afforded some of the same structuring relief as QOFs, so QOZB mergers are fine and do not jeopardize the status of the QOZB equity held by the QOF(s) or the status of the property held by the QOZB.

b. Maybe a little isn't so bad – De minimis sin businesses

The Final Regulations offer a bit of relief on the all-or-nothing sin business rule in the Code. As long as any operation of, or leasing space to, a sin business is de minimis (less than 5% of the QOZB's gross income, or less than 5% of the rentable square feet for real property), the QOZB can satisfy the sin business prohibition.

c. The workings of the working capital safe harbor

The 31-month working capital safe harbor ("WCSH") remains largely intact, and remains a key part of QOZB compliance. The Final Regulations do tighten up the tolling rules, which now require that a project actually be delayed as a result of waiting for government approvals in order to toll the 31-month period. Additionally, if the project is in a federally declared disaster area, the QOZB can take another 24 months to spend the cash noted in its WCSH.

QOZBs can still use multiple sequential or overlapping WCSHs, but the total time period cannot exceed 62 months (essentially two back-to-back WCSH periods).

Helpfully, the Final Regulations clarify that tangible property purchased, leased, or improved according to the written plan during the WCSH period (including overlapping or sequential safe harbor periods) counts as qualified opportunity zone business property ("QOZBP") during all working capital

periods. This rule suggests that all property constructed during the entire working capital safe harbor period would be good tangible property for purposes of applying the 70% test.

d. First time buyers – Original use

Treasury clarified a number of issues related to the original use test.

i. Pave your own way – Self-constructed property

QOZBP must be acquired by purchase from an unrelated party after December 31, 2017. We had assumed (based on other provisions in the tax law) that self-constructed property would meet this purchase requirement, and the Final Regulations confirmed this interpretation. Self-constructed property can be QOZBP, so long as the construction begins after December 31, 2017 and as long as the materials and supplies used in construction themselves satisfy the purchase requirement.

Self-constructed property is treated as acquired on the date that significant physical work begins. This does not include preliminary work such as planning or designing, securing financing, or exploring or researching. The QOZB can instead elect to use a safe harbor, which pins the acquisition date as the date on which more than 10% of the total cost of the property is paid or incurred, excluding the cost of land and any preliminary work.

ii. Shiny new buildings – Use the placed in service date

By linking the original use test to the placed in service date (when depreciation starts) in the Proposed Regulations, Treasury opened the door to OZ Program investments involving the acquisition of newly constructed property that had not yet been placed in service. Treasury confirmed in the Final Regulations that this is a viable acquisition by a QOZB, which is helpful comfort.

Notably, Treasury stated in the preamble to the Final Regulations that they declined to provide a requested safe harbor that would allow a QOZB to treat property as placed in service upon the issuance of a certificate of occupancy, since the standards for a C.O. vary across local jurisdictions. Accordingly, we suggest that you be cautious about relying solely on the T.C.O. or C.O. to meet the original use test.

Also, if you have an existing building in an Opportunity Zone, Treasury clarified that new improvements to existing property cannot themselves qualify as original use property. Under that scenario, you have to meet the substantial improvement (double your basis) requirement. Lessee improvements, however, can be treated as QOZBP by the lessee.

iii. Empty road ahead – Vacancy periods

In the Proposed Regulations, Treasury tried to encourage the redevelopment of vacant buildings by permitting such redevelopment to qualify as original use property, but required the building to have been vacant for at least 5 years.
The Final Regulations reduce the vacancy period to 3 years, and this period is further reduced to just 1 year if the building was vacant when its location was designated as an Opportunity Zone. For a building to be considered vacant, at least 80% of its square footage must be unused.

iv. Cleaning it up – Brownfield sites

One of the brand new provisions in the Final Regulations is the inclusion of Brownfield sites as original use property. There is no substantial improvement requirement or other placed-in-service requirement applicable to Brownfield sites so long as, within a reasonable period (which is not defined), the QOZB makes investments in the Brownfield site to ensure that all property composing the site meets basic safety standards for both human health and the environment. Remediation of contaminated land is taken into account for purposes of determining whether the land has been more than minimally improved.

v. Out in the country – Minimally improved land

One of the lingering uncertainties from the Proposed Regulations was the treatment of unimproved land. Land used in the trade or business of a QOZB could be included as QOZBP (without an original use or substantial improvement requirement), but otherwise unimproved or minimally improved land could only be included as QOZBP if there was an expectation or intention to improve the land by more than an insubstantial amount within 30 months.

Treasury declined to provide a bright line percentage value test to determine what constitutes more than an insubstantial improvement, so the Final Regulations rely on facts and circumstances for purposes of this determination. However, the Final Regulations do indicate by way of example that improvements such as grading, clearing, or remediation, or the acquisition of related QOZBP that facilitates the use of the land by the QOZB, will be taken into account.

e. Doubling up – Substantial improvement

Treasury added some welcome flexibility on property qualifying as QOZBP under the substantial improvement test.

i. One big happy… New aggregation rules

An existing building can be QOZPB only if improvements made within a 30-month period double its basis. Under the Proposed Regulations, this substantial improvement test was required to be met on an asset by asset basis, so no aggregation was possible. The Final Regulations now permit 2 types of aggregation.

First, the Final Regulations allow a group of buildings to be treated as a single property if the buildings are all located on a parcel described in a single deed. Even if that is not the case, the group can qualify for aggregation if each building in the group is operated by the QOZB in one or more trades or businesses, shares some overhead functions, and is operated in coordination with, or reliance upon, one or more of those trades or businesses. For example, a QOZB can acquire two used buildings for $100 each (for a total of $200), and both buildings can qualify as substantially improved under the Final Regulations if the improvements cost $200 or more overall, even if most or all of the improvements are made to just one of the buildings.

Second, the Final Regulations allow newly purchased tangible property that would otherwise qualify as original use property, such as newly acquired furniture, fixtures and equipment, to be treated instead as part of a building's improvements, so that their cost can be taken into account for purposes of determining whether basis has been doubled. To qualify, the tangible property must be used in the same trade or business as the building, and must also improve the building's functionality. For example, if a QOZB buys a used hotel to renovate, the QOZB can count the cost of newly purchased linens, mattresses and furniture towards the double-your-basis requirement.

These new provisions should help to increase the number of OZ Program investments in buildings that are already in use in Opportunity Zones.

ii. Cruise control is on – Safe harbor for substantial improvement

The substantial improvement test got its very own start-up safe harbor in the Final Regulations. As long as the property is expected to meet the substantial improvement test at the end of the 30-month period, the QOZB can treat that property as QOZBP during the 30-month period even if the QOZB has not yet doubled its basis in the property.

IV- The road continues…

There is much more to say, and much more to continue to study, about the Final Regulations. Additionally, tax guidance is an evolving process, so expect additional clarity on some of these issues in 2020 (and even beyond that). Here are a few final takeaways:

a. Keep your nose clean – Anti-abuse rules

The Final Regulations include a broad anti-abuse rule that permits the IRS to recharacterize a transaction if it is inconsistent with the purposes of the OZ Program (which are to provide specified Federal income tax benefits to owners of QOFs, to encourage the making of longer-term investments of new capital in one or more Opportunity Zones through QOFs and QOZBs, and to increase the economic growth of Opportunity Zones). The determination of whether a transaction or tax benefit is inconsistent with the purposes of the OZ Program is based on all relevant facts and circumstances.

There are a few clarifying examples in the Final Regulations illustrating scenarios intended to achieve a tax benefit that is inconsistent with the purposes of the OZ Program, including creating a parking lot to minimally improve land while waiting for the land value to appreciate. Another example involves funding a QOF with eligible gain, and using that gain to acquire non-Opportunity Zone property (so that a penalty is imposed each year), with a view toward selling the QOF after 10 years on a tax-free basis after the non-Opportunity Zone property has appreciated.

Treasury explicitly did not include a general good faith exception to the anti-abuse rule, so be sure your project is in line with the OZ Program purposes.

b. Changing signs – Reliance and effective dates

The Final Regulations will not be in full force and effect until 2021,[2] but you can rely on them now if helpful, as long as you do so consistently. Alternatively, you can continue to rely on the Proposed Regulations until 2021.

[2] The Final Regulations generally apply to taxable years beginning after the date that is 60 days after they are published in the Federal Register. Depending on when this publication occurs, the effective date will be sometime in the first quarter of 2020. For individuals, and for entities that file on a calendar-year basis, that means that the Final Regulations will take effect in 2021.

c. There is always more road to walk – Additional topics in the Final Regulations

The Final Regulations were chock full of additional clarity on a number of issues we did not explicitly address in this road map, including QOF reinvestment rules for non-US investors, the treatment of installment sale gain as eligible gain, the treatment of boot in a reorganization as an inclusion event, the mechanics of basis adjustments as a result of inclusion events, identification alternatives for dispositions of QOF interests, additional detail on the 50% gross income requirement, further guidance on the intangible property requirement, the treatment of inventory, clarifications with respect to property partly in and partly outside of an Opportunity Zone, and additional guidance on leases.

The D&S Opportunity Zone Practice Group brings together a 50-person team, including lawyers, paralegals, and our business professionals providing a unique value add for clients. The OZ team is led by:

- Stephen Land (Tax Practice Chair) 212-692-5991 / sland@dsllp.com
- Terri Adler (Managing Partner) 212-692-5533/ tadler@dsllp.com
- Bruce Stachenfeld (Chairman) 212-692-5550 / bstachenfeld@dsllp.com

This memorandum is provided by Duval & Stachenfeld LLP for educational and informational purposes only and is not intended and should not be construed or relied upon as legal or tax advice. A taxpayer's ability to claim tax benefits depends on the individual taxpayer's circumstances. No tax benefits are guaranteed as a result of investing in a Qualified Opportunity Fund. ***Potential investors should consult their tax advisers with respect to the U.S. federal income tax consequences of an investment in a Qualified Opportunity Fund.***