Do You Hear the People Sing? A Guide to the Final O-Zone Regs

POSTED ON JAN. 6, 2020

By

MARIE SAPIRIE
Contact Author

The maxim about the best gifts coming in small packages doesn't apply to the final Opportunity Zone regulations package. It's massive and includes plenty of pleasant surprises for investors, as well as a handful of encouraging developments for local communities.

The regulation writers at Treasury and the IRS and the reviewers at the Office of Management and Budget's Office of Information and Regulatory Affairs deserve commendation. They made good on their promise to deliver the final Opportunity Zone regulations before the end of the year (T.D. 9889). OIRA reviewed the hefty final rules package in only eight business days. How hefty is it? The Opportunity Zone rules are as long as the final Foreign Account Tax Compliance Act rules (T.D. 9610), issued in 2013, or about half as long as Victor Hugo's *Les Miserables*.

> ***Putting entity sales and asset sales on a more or less equal footing is a major change from the proposed regulations that will make setting up multi-asset funds much easier, Millett said.***

Will investors have to make any detours through the sewers? Or are the final rules a lengthy story of redemption for a flawed statute? The Opportunity Zone regime's progenitor, the Economic Innovation Group, was pleased with the final regs' direction, saying they helped fulfill Congress's intention. Would-be investors probably will be pleased, too. (Prior coverage: *Tax Notes Federal*, Dec. 23, 2019, p. 1989.) One trend in the final rules is that Treasury and the IRS identified potential obstacles to investor participation in the regime and knocked them down one by one, said Jessica Millett of Duval & Stachenfeld LLP.

Final regulations are important for the market because they provide stability for deal structuring, said Jonathan Talansky of King & Spalding LLP. The Economic Innovation Group's president, John Lettieri, said the changes to the rules regarding vacancies, brownfields, and government-owned property in particular will have a ripple effect on Opportunity Zone communities, including creating paths for operating businesses to move in and make it easier for investors to fulfill the local community's needs.

Exits Simplified

The regs solidified the rules on the treatment of exits from qualified opportunity funds, mostly along the lines of what taxpayers had hoped. The final rules allow sales of property at either the QOF level or the qualified Opportunity Zone business level to help entice investors into the market because they now know they can dispose of interests in qualified Opportunity Zone businesses at different times. The preamble explains that the disposition of QOF assets, including interests in qualified Opportunity Zone businesses, should qualify for the election under section 1400Z-2(c) if it meets the 10-year holding period, because requiring a single disposition of all QOF assets would encourage QOFs and their investors to dispose of a qualified Opportunity Zone business at a point when they wouldn't otherwise do so.

Putting entity sales and asset sales on a more or less equal footing is a major change from the proposed regulations that will make setting up multi-asset funds much easier, Millett said. Not knowing whether asset sales would be an approved means of exit was likely causing some capital gains to sit on the sidelines. (Prior analysis: *Tax Notes*, Mar. 4, 2019, p. 969.)

Talansky noted that the final regulations allow the merger of two QOF partnerships. That provision serves as a bridge between the proposed rules and the final rules by setting up a mechanism for funds with multiple QOFs to collapse them into a single QOF. "There were a lot of single asset deals split among different QOFs, because investors wanted to retain flexibility," he said.

Gross Section 1231 Gains

The section 1231 gain rules include an unexpected gift to investors. No longer must they wait until the end of the year to net their section 1231 capital gains against their section 1231 capital losses, because the netting requirement is now gone. If investors have gains under section 1231 that need not be characterized as ordinary income, they can defer them under section 1400Z-2(b).

However, section 1231(c) still applies to recapture net ordinary losses, so if an investor made a deferral election for an eligible section 1231 gain in 2019, when it's included in income on December 31, 2026, any non-recaptured section 1231 losses from the five preceding years are included. It was clear that Treasury and the IRS would fix the problem of investors with section 1231 gains having to wait until December 31 to net and reinvest them, but the final regs are more generous than even most of the commentators had dared hope. The preamble says Treasury and the IRS abandoned netting because it added complexity and that the change is consistent with the ordinary income rules under section 64.

> ***No longer must investors wait until the end of the year to net their section 1231 capital gains against their section 1231 capital losses, because the netting requirement is now gone.***

Investors still must pay for the legal and accounting legwork that went into preparing to invest section 1231 gains accrued in 2019, but subsequent years will be less painful. Because no one knew what the final rules would be, if taxpayers had net section 1231 gains, they would have needed to be ready to net and invest them on December 31. There was still a flurry of activity at the end of the just-ended year.

Vacant and Purchased Buildings

Attracting investment to renovate vacant buildings was apparently important to Treasury, because the final regulations drop the vacancy period requirement from five years before purchase by the QOF or qualified Opportunity Zone business to one year for property that was vacant before the zone's designation notice, or three years for property that wasn't vacant at the time of the zone designation but later became vacant. The three-year period is meant as a guardrail to keep QOFs and qualified Opportunity Zone businesses from intentionally leaving property vacant to convert it into original use property.

The final rules don't adopt a bright-line test for original use like the date of a certificate of occupancy, but they explain how to determine the date that tangible property is first placed in service. Reg. section 1.1400Z2(d)-2(b) provides a taxpayer-friendly example that allows a QOF or qualified Opportunity Zone business to purchase a new building from a developer and still treat it as original use property, Lesley P. Adamo of Lowenstein Sandler LLP noted.

Safe Harbor Modifications

Start-ups can stack safe harbor periods for a total of 62 months, as long as each 31-month period satisfies the requirement for applying the working capital safe harbor. The working capital still must be used within 31 months, but now Treasury and the IRS agree that two safe harbor periods can be stacked if there are multiple infusions of cash. Investors will likely view this "confirmation" of the rule, as the preamble calls it, as a helpful addition.

The October 2018 proposed regulations (REG-115420-18) offered 31 months. The final rules require that working capital subject to an expiring 31-month period be expended in accordance with the section 1400Z-2 regulations, and the subsequent infusions of cash must form an integral part of the plan covered by the initial 31-month safe harbor. For most projects, the stacked 62-month period will be about right, Millett said.

The regs allow tolling attributable to a governmental permitting delay as long as there's no foot-dragging. Treasury and the IRS reasonably concluded that tolling of the 31-month period for governmental permitting delays should be disallowed if other parts of the project could be progressing during that time.

Substantial Improvement

The final regulations move away from an asset-by-asset approach to determining whether the substantial improvement requirement of section 1400Z-2(d)(D) is met. For the most part, they allow asset aggregation in establishing whether a non-original-use asset has been substantially improved, although the purchased assets must be used in the same trade or business in the qualified Opportunity Zone or a contiguous one and improve the functionality of the non-original-use asset in the same or contiguous zone. That change helps both real estate and operating businesses, Talansky said. The preamble and the final rules give the example of a hotel and explain that the QOF can include original use purchased assets in the basis of the purchased hotel to meet the substantial improvement requirement if the assets are "integrally linked to the functionality of the hotel business." Such assets would include mattresses, linens, and furniture.

Purchased real property must be improved by more than an insubstantial amount. If taxpayers elect the aggregation approach, they must take into account the basis of the purchased property in determining whether the additions to the basis of the non-original-use property satisfy the requirements for qualified Opportunity Zone business property.

> ***With the new ability to buy two buildings on the same lot and aggregate the amount of money spent on them, as well as counting purchased property, the final rules open up a new category of deals that before were less likely to happen.***

Aggregation of buildings is now possible in some circumstances. Taxpayers can apply money spent on one building to meet the substantial improvement requirement for another building, even if those buildings are distinct assets or on separate parcels, as long as there's a nexus that satisfies the rules, Talansky said. The required connections are that the buildings must be operated exclusively by the QOF or qualified Opportunity Zone business, share facilities or centralized business elements, and be operated in coordination with one or more of the trades or businesses of the QOF or qualified Opportunity Zone business. Those thresholds aren't always required when the buildings in a given group are on the same parcel and designated on the same deed.

Millett said the changes to the substantial improvement test add a lot of welcome flexibility that may make qualifying under that test more attractive for future deals. She said the original use test tended to be more popular because of its relative simplicity. Doubling the basis in purchased property through renovation didn't always seem feasible for existing buildings, and the prior iteration of the substantial improvement test in the proposed rules meant finding the right deal to make the numbers work out. With the new ability to buy two buildings on the same lot and aggregate the amount of money spent on them, as well as counting purchased property, the final rules open up a new category of deals that before were less likely to happen.

Investment Period for Partners and Shareholders

The final rules allow partners, shareholders of an S corporation, and beneficiaries of decedents' estates and non-grantor trusts to treat the 180-day period for investment as beginning on the due date of the entity's tax return, not including extensions. Adamo said that change is particularly helpful when the entity isn't closely held, because equity holders may not receive notice of passthrough gains until they receive their Schedule K-1.

Triple Net Leases

The final regs cover no new ground regarding triple net leases. They stick with the notion that merely entering into a triple net lease doesn't constitute the active conduct of a trade or business. One of the examples approves a particular triple net leasing fact pattern as meeting the active conduct of a trade or business requirement. Government officials spent plenty of time over the past six months agreeing publicly that in some cases, taxpayers that use a triple net lease as part of their leasing business could be treated as conducting an active trade or business under section 1400Z-2(d)(3)(A). The final regulations leave taxpayers in essentially the same spot they were in before.

DOCUMENT ATTRIBUTES

CODE SECTIONS	SEC. 1400Z-2 SPECIAL RULES FOR CAPITAL GAINS INVESTED IN OPPORTUNITY ZONES. SEC. 1231 PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS
JURISDICTIONS	UNITED STATES
SUBJECT AREAS / TAX TOPICS	OPPORTUNITY ZONES CAPITAL GAINS AND LOSSES PROPERTY TAXATION
MAGAZINE CITATION	TAX NOTES FEDERAL, JAN. 6, 2020, P. 32 166 TAX NOTES FEDERAL 32 (JAN. 6, 2020)
AUTHORS	MARIE SAPIRIE
INSTITUTIONAL AUTHORS	TAX ANALYSTS
TAX ANALYSTS DOCUMENT NUMBER	DOC 2019-48559
TAX ANALYSTS ELECTRONIC CITATION	2020 TNTF 3-5