CAPITOL TAX PARTNERS

Summary of Selected Issues in Final Opportunity Zone Regulations

On December 19, 2019, the Treasury Department and IRS (collectively, "Treasury") released final regulations regarding investments in qualified opportunity funds. These regulations finalize rules found in two sets of proposed regulations that were released in October 2018[1] and April 2019.[2]

The final regulations are 543 pages long, including a preamble of roughly 350 pages. Accordingly, this summary is not meant to be a comprehensive listing of all changes in the final regulation, but rather is intended to highlight modifications of several selected issues related to the proposed regulations that were of significant interest to taxpayers.[3]

Summary

REIT and RIC Capital Gain Dividends. The proposed regulations began the 180-day investment period under section 1400Z-2(a)(1)(A) for REIT and RIC dividends on the date the dividend was received. Comments stated this caused a problem because REITs and RICs do not determine whether a dividend was a capital gain until the tax year has ended.

To address this problem, the final regulations provide that the 180-day investment period for REIT or RIC capital gain dividends generally begins on the last day of the shareholder's tax year in which the capital gain dividend would otherwise be recognized by the shareholder.[4] A taxpayer may elect, however, to begin the 180-day period on the day each capital gain dividend is paid, or in the case of undistributed dividends, at the end of the RIC or REIT's taxable year.[5] In any case, the aggregate amount of a shareholder's eligible gain from such dividends cannot exceed the reported amount of the capital gains dividends received by the shareholder; any excess investments will be non-qualifying.

Aggregation to meet substantial improvement test. In the proposed regulations, Treasury requested comments on whether a rule allowing taxpayers to determine whether they substantially improved property for purposes of section 1400Z-2(d)(2)(ii) by using an aggregate method rather than an asset-by-asset method. Responding to several comments, the final regulations allow taxpayers to aggregate assets for purposes of determining whether they meet the substantial improvement standard.[6] For purposes of determining whether the substantial improvement test is met, qualified opportunity funds (QOFs) can take into account purchased original use assets if the assets are located in the same qualified opportunity zone (QOZ) as the

[1] REG-115420-18.
[2] REG-120186-18.
[3] If you have any questions about items addressed in the final regulations (whether covered by our summary or not), please reach out to us and we would be happy to answer them.
[4] Reg. §1.1400Z2(a)-1(b)(7)(ii)(A).
[5] Reg. §1.1400Z2(a)-1(b)(7)(ii)(B).
[6] Reg. §1.1400Z2(d)-2(b)(4)(iii).

non-original use property, used in the same trade or business as the non-original use asset, and improve the functionality of the non-original use assets in the same QOZ.[7]

Section 1231 gains. Under the proposed regulations, only net capital gain arising from all of a taxpayer's section 1231 property in excess of all section 1231 losses was eligible gain.[8] The final regulations modify this rule and determine eligible section 1231 gains on an item-by-item basis, without regard to any section 1231 losses, also known as the "gross approach."[9] In other words, to the extent 1231 gain is not required to be recharacterized as ordinary income under sections 1245 or 1250, it would be eligible gain regardless of whether section 1231(a) would treat such gains as capital or ordinary. Also, because gains are determined when the section 1231 property is disposed, the 180-day period for investment under section 1400Z-2(a)(1)(A) will begin when the item is sold, rather than at the end of the year as under the proposed regulations.

Offsetting position transactions. The final regulations significantly change the rules regarding gains attributable to offsetting position transactions. Under the proposed regulations, eligible gain did not include any gain attributable to any position that had ever been part of an offsetting position transaction. For purposes of the proposed regulations, an offsetting positions transaction was a transaction in which the taxpayer substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding other positions. This definition of an offsetting positions transaction was significantly broader than the definition of a straddle used in section 1092, for example, because it included non-actively traded property.

Responding to comments that the definition of offsetting positions transaction was too broad, Treasury narrowed the definition to only include straddles under section 1092. Treasury also conceded that excluding gains attributable to positions that have ever been part of an offsetting positions transaction was too broad of a rule. Thus, the final regulations only exclude the use of gains from a straddle to the extent the net gain is attributable to a position that was part of a straddle in the current year or a prior tax year if a loss from that straddle is carried over into the current taxable year.

Additionally, Treasury provides that if during a year (1) a position was covered by an identification under section 1092 or 1256(d), (2) no gain or loss with respect to any position that was part of the identified position remains unrecognized at the end of the tax year (other than gain that would be recognized but for deferral under section 1400Z), (3) none of the positions in the identified straddle were part of any other straddle during the tax year, and (4) none of the positions in the identified straddle were part of a straddle in a previous tax year from which a loss was carried over to the tax year under section 1092(a)(1)(B), then the net gain from positions that were part of the identified straddle is not prevented from being an eligible gain.

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[7] Preamble at pg. 189. For additional examples and rules related to substantial improvement of non-original use real property, see reg. §§1.1400Z2(d)-2(b)(4)(iii)(D) and -2(b)(4)(iv) and (v).
[8] Section 1231 property is generally any depreciable property or real property used in a trade or business and held for more than one year. Net gain from the sale of section 1231 property in a tax year is treated as long-term capital gain and net loss from the sale of section 1231 property is treated as ordinary loss.
[9] Reg. §1.1400Z2(a)-1(b)(11) and Preamble at pgs. 11-17.

Section 1256 Contracts. The proposed regulations only allowed net capital gain from all of a taxpayer's section 1256 contracts, which are marked-to-market annually, to be eligible gains for purposes of the opportunity zone rules. Also, if at any time during the tax year any of the taxpayer's 1256 contracts were part of an offsetting positions transaction, then the proposed regulations would not have treated any gain from a 1256 contract as eligible gain for purposes of the opportunity zone regulations. Under the final regulations, net gain from 1256 contracts that were not part of a straddle may be eligible gain.

Profits interests. The final regulations make small changes to the treatment of profits interests. The proposed regulations treated a partner holding a mixed-funds investment in a QOF partnership as holding separate interests in the partnership – a qualifying investment and a non-qualifying investment – solely for purposes of section 1400Z-2. Under the proposed regulations, distributions and allocations to the mixed-funds partner were allocated to the separate interests based on the relative capital contributions attributable to the qualifying and non-qualifying investment. If a mixed-funds partner received a profits interest in exchange for services, however, the proposed regulations treated the profits interest as a non-qualifying investment and the allocation percentage for the profits interest was based on the highest share of residual profits the partner would receive with respect to that interest.

Treasury kept the general mixed fund allocation rule, but slightly amended the profits interest rule to require mixed-fund partners to allocate to the profits interest an amount equal to the share of the residual profits the partner would receive with respect to the profits interest.[10] The final regulations also provide that an allocation of residual profits for which there is not a reasonable likelihood of application will be disregarded in determining the allocation percentages. Thus, the allocation percentage for the profits interest will be the final share of profits provided in the partnership agreement that is likely to apply. Treasury declined to adopt alternative approaches suggested by commenters because the general approach in the proposed regulation is "simpler and more administrable."[11]

Sale of qualified opportunity zone business property after 10-year holding period. The proposed regulations allowed an investor in a QOF partnership or QOF S corporation to exclude gain, in whole or in part, from the QOF's sale of qualified opportunity zone business property satisfying the 10-year holding period requirement in section 1400Z-2(c). There was confusion, however, whether a QOF that holds multiple qualified opportunity zone businesses may dispose of each business at separate times and exclude gain under the 10-year holding period rule for each disposition. The final regulations allow a QOF partnership or a QOF S corporation to dispose of interests in qualified opportunity zone businesses at different times and still qualify for the basis adjustments and gain exclusion under section 1400Z-(2)(c). According to the preamble, this rule provides flexibility to QOFs to help promote the economic success of the QOF and avoids the inefficiency which could result if a QOF were required for tax reasons to dispose of all of its qualified opportunity zone businesses at the same time.

[10] Reg. §1.1400Z2(b)-1(c)(6)(iv)(D). §1.1400Z2(b)-1(c)(6)(iv)(E) contains two examples on the profits interest allocation issue.
[11] Preamble at pg. 91.

Working Capital Exception. The proposed regulations allowed working capital to be considered qualified opportunity zone business property for up to 31 months if the taxpayer could show the working capital meets certain requirements, including being subject to a plan for the construction, acquisition, or improvements of tangible property. The proposed regulations also treated business development as a planned use of working capital. If a taxpayer exceeded the 31-month limitation, it did not violate the safe harbor if the delay was attributable to government action.

The final regulations clarify that, if a governmental permitting delay has caused the delay of a project covered by the 31-month safe harbor, then the safe harbor will be tolled for the duration of the delay.[12] If a government permitting delay has caused the delay of a project covered by the 31-month safe harbor, and no other action could be taken to complete the project during the delay, then the 31-month safe harbor will be delayed for the duration of the delay. The final regulations also allow for a project within a Federally declared disaster area to receive an additional 24 months to use its working capital so long as the disaster caused a delay in the project.[13]

The regulations also clarify that businesses may utilize multiple working capital safe harbors, provided that each separately meets the regulatory requirements. If a business uses multiple working capital safe harbors for the same piece of tangible property, the maximum length of time the safe harbor can last is 62 months.[14]

Lastly, the final regulations create a 62-month safe harbor for start-up businesses.[15] The 62-month working capital safe harbor provides that non-qualified financial property in excess of five percent will not cause a trade or business to fail to qualify as a qualified opportunity zone business and gross income earned from the trade or business will be counted toward satisfying the 50-percent gross income requirement. Additionally, tangible property purchased, leased, or improved by the business will count toward the 70-percent standard, and intangible property purchased or licensed with the cash pursuant to the plan will count towards the satisfaction of the 40-percent intangible property use test. A start-up business qualifies for a 31-month safe harbor upon the businesses' first cash infusion, and it can extend the safe harbor for another 31 months upon receipt of a second cash infusion.

Vacancy Period for Original Use Requirement. The proposed regulations provided that if property has been unused or vacant for an uninterrupted period of at least five years, original use will begin on the date after the vacancy period when any person first uses or places the property in service in the QOZ.

The final regulations modify this five-year requirement in two ways. First, if the property was vacant at the time the zone was originally designated as a QOZ, the requisite vacancy period is shortened to one year.[16] Second, with respect to property that was occupied at the time of QOZ

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[12] Reg. §1.1400Z2(d)-1(d)(3)(v)(C).
[13] Reg. §1.1400Z2(d)-1(d)(3)(v)(D).
[14] Reg. §1.1400Z2(d)-1(d)(3)(v)(F).
[15] Preamble at pgs. 232-234.
[16] Reg. §1.1400Z2(d)-2(b)(3)(i)(B).

designation but that later became vacant, the final regulation requires the property be vacant for at least three years.[17]

QOF Exit and Reinvestment. The final regulation notes that commenters requested that the regulations should allow an investor to dispose of its interest in a QOF and reinvest the proceeds in a new QOF, and carryover the holding period from the original investment. The Treasury Department rejected this request. Upon disposing of an interest in a QOF an investment into another fund results in a new holding period.

Additionally, the final regulations make clear that in the event a taxpayer disposes of its entire investment in an QOF with the intent to reinvest in another QOF, the taxpayer is again subject to a new 180-day reinvestment period.[18]

Finally, in the event that a taxpayer disposes of its entire investment to reinvest in a different QOF, the taxpayer must invest in the new fund before the Opportunity Zone program expires on December 31, 2026.

Triple-net-leases. The proposed regulations stated that merely entering into a triple-net-lease with respect to real property owned by the taxpayer does not constitute an active trade or business for purposes of the opportunity zone rules. Treasury received several comments suggesting that certain fact patterns in which a taxpayer enters into a triple-net-lease should constitute the active conduct of a trade or business.[19] Treasury maintained its general rule from the proposed regulations that merely entering into a triple-net-lease does not constitute an active trade or business. The final regulations, however, provide an example showing that in certain circumstances the use of a triple-net-lease as part of the taxpayer's business does not preclude the business from being an active trade or business.[20]

Acquiring an interest from a person other than the QOF. The proposed regulations allowed a taxpayer to make a deferral election under section 1400Z-2(a)(1)(A) for an eligible interest acquired from a person other than a QOF. The regulations were unclear, however, whether the acquiring taxpayer could make the election if the transferor had not made the election.[21] The final regulations allow acquiring taxpayers to make the deferral election regardless of whether the transferor made an election to defer gains. Also, entities that existed before enactment but later became QOFs are eligible interests for an investor, even though not qualifying investments in the hands of the transferor.

Specific Identification. The proposed regulations required taxpayers disposing of QOF interests that were acquired on different days to use the first-in-first-out (FIFO) accounting method to determine which interests were disposed. If FIFO did not work for a specific taxpayer, the taxpayer was required to use a pro rata method to determine holding period and basis. The final

[17] *Id.*
[18] Reg. §1.1400Z2(a)-1(b)(7)(iv)(D).
[19] See Preamble at pgs. 237-240.
[20] Reg. §1.1400Z-2(d)-1(d)(3)(iii).
[21] See Preamble at pg. 51.

regulations allow taxpayers to use specific identification rather than FIFO when disposing stock in a QOF.[22]

Tax Rates. Under the proposed regulations, if a taxpayer has an inclusion event under sections 1400Z-2(a)(1)(B) and (b), then the gain in the inclusion year has the same tax attributes as it would have had if the tax had not been deferred. The proposed regulations did not, however, clarify whether the tax rates applicable to the deferral year apply to the inclusion year. The final regulations require taxpayers to use the applicable Federal income tax rate in the year of the inclusion event rather than the tax rates applicable to the deferral year.[23]

Partnership, S corporation, and trust beneficiaries 180-day rule. The proposed regulations provide that the 180-day investment requirement begins on the last day of the partnership tax year in which the partner's allocable share of eligible gain is taken into account under section 706(a). The regulations allow a partnership to make an election to defer the gain, but if the partnership does not make the election, the partner may elect to deferral its eligible gain and begin the 180-day rule on the last day of the partnership's tax year. Because partners and shareholders may not know whether the entity made an election due to the timing of Schedule K-1 issuances, the final regulations allow a partner, S corporation shareholder, and beneficiaries of decedents' estates and non-grantor trusts to begin the 180-day period on the due date of the entity's tax return, not including any extensions.[24]

[22] Reg. §1.1400Z2(a)-1(c)(2).
[23] Preamble at pgs. 105-106.
[24] Reg. §§1.1400Z2(a)-1(b)(7)(iii), (c)(8), (c)(9).