



Opportunity Zones: Changes and Additions in the Final Regulations

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Section 1231 Assets

Under the proposed regulations, taxpayers had to wait until the end of the taxable year to determine the amount, if any, of Section 1231 gains that could be reinvested in a QOF for favorable tax treatment. In addition, the 180-day window for investing such gains began on December 31, rather than the actual date the Section 1231 assets were disposed. Under the final regulations, taxpayers may immediately contribute Section 1231 gains to a QOF rather than waiting for a netting process at the end of the year. If a Section 1231 gain is invested in a QOF and deferred, a Section 1231 loss in the same year, which otherwise would have reduced 1231 gains, will now become a net Section 1231 loss (recognized as an ordinary deduction). Relatedly, any Section 1231 gains reinvested in 2019 or 2020 will not be recognized until 2026, meaning any Section 1231 net losses realized in 2019 or 2020 will be outside of the 5-year recapture window for Section 1231 assets.

Installment Method Asset Sales

If a taxpayer sells an asset with installment payments that gives rise to an eligible gain, the taxpayer can defer the gain on each of the installment payments (until 2026), even if the initial sale giving rise to the payments occurred prior to 2018. As far as the 180-day reinvestment window, taxpayers can choose to have a 180-day window for each payment received, or choose a single reinvestment window beginning on the last day of the taxable year. Example: If a taxpayer receives quarterly payments in January, April, July, and October, the taxpayer may elect to have four 180-day periods, (beginning in January, April, July, and October), or instead one period beginning on December 31, 2019, during which the gain from all four payments can be reinvested.

180-Day Reinvestment Period for Gains from Pass-Through Entities

Under the initially proposed regulations, partners' or shareholders' 180-day reinvestment window for gains allocated from a pass-through entity did not begin on the date of the sale, but instead on the last day of the entity's tax year. The proposed regulations also allowed partners or shareholders to elect to treat the 180-day reinvestment period as being the same as the entity's 180-day reinvestment period, which begins on the date of the sale by the entity. This would allow a partner or shareholder to reinvest eligible gains into a QOF sooner. The final regulations offer an additional election option for owners of pass-through entities: they may elect to begin the 180-day reinvestment period on the due date for the pass-through entity's tax return, without extensions, which will allow these tax payers an extended time period to reinvest gains.

Reinvestment of Gains from Disposition of QOF Interest

If a taxpayer sells a QOF interest that was subject to a gain deferral election, the taxpayer may make a second election to further defer the recognition of the original deferred gain, if the taxpayer reinvests the gain amount within 180 days in the same or another QOF. Under the proposed regulations, the taxpayer had to sell its entire interest in the QOF in order to make a second deferral. The final regulations have modified this provision to provide that a partial disposition of a QOF interest can also be deferred a second time by reinvesting within the 180-day window.

Original Use Test

The general rule is that in order to be considered QOZBP, property must have never before been used in the QOZ (the “original use” test), or must be “substantially improved”. Since the QOZ program’s inception, questions have been raised about vacant property and whether it could at some point meet the original use test. The proposed regulations allowed this test to be satisfied if the property had sat vacant for at least five years. The final regulations reduce this time frame to three years, if the vacancy has occurred for at least three years after the designation of the area as a QOZ (all of such designations were made in 2018). The final regulations also provide for a shorter time period of one year if the property was vacant for at least one year on the date the location was designated as a QOZ. By way of illustration, if a QOF purchases property that was vacant for one year on the date the location was designated as a QOZ and remains vacant until the QOF places it into service, the property will satisfy the original use test. If instead, the property was vacated four months after the area were designated as a QOZ and sat vacant for three years after that date, a QOF could purchase the property and immediately place it into service and satisfy the original use test.

“Substantial Improvement” Flexibility

The “substantial improvement” test offers an alternative to the original use test in order to qualify as QOZBP. Property meets this test if during any 30-month period beginning after the date of acquisition of the property, the QOF spends as much to improve the property (measured by additions to basis) as the its original basis in the property (original basis not including the value of the land) at the beginning of the 30-month period. The biggest change in the final regulations to the substantial improvement provisions is the additional flexibility given in meeting the test. A QOF can improve its property by purchasing other property that satisfies the original use test independently, so long as the additional property adds to the functionality of the property subject to the substantial improvement test. (Example: A hotel being substantially improved can add the costs of items like new linens, mattresses, furniture, and exercise equipment to the basis of the hotel for purposes of determining if it has met the substantial improvement test.)

In addition, the final regulations provide that in limited circumstances, a QOF that owns several buildings within a QOZ may aggregate the basis and improvements made to the buildings for purposes of the substantial improvement test.

QOF Asset Sales after Ten Years

After the second round of proposed regulations, there existed some disparities in how dispositions of assets would be treated based on whether the assets were sold by the QOF (and gains passed through to the partners or shareholders), or whether the partners or shareholders disposed of their interests directly. If an investor sells its interest in the QOF, ALL of its gain can be excluded from income. If instead the QOF sells assets, the proposed regulations provided that only capital gain could be excluded. So, if the QOF sold inventory or assets subject to ordinary income depreciation recapture, it would result in a degree of ordinary income recognition by investors. The final regulations broaden the exclusion of assets sold by a QOF, and as it stands now, only ordinary income from the sale of inventory is required to be recognized. Other types of ordinary income will be excluded. The final regulations also provided that QOFs may sell off their assets piecemeal and taxpayers can make multiple elections to exclude flow-through disposition gains, which is welcome clarification for multi-asset real estate QOFs.

Basis of Inherited QOF Interest

The final regulations clarify that if a QOF Interest is passed to a beneficiary upon the death of the original holder, Section 1014 (which provides beneficiaries with a stepped-up FMV basis in property received) is not applicable, and the basis will remain whatever it was before the decedent's death (i.e., \$0, unless the investor had reached the 5- or 7-year mark).

Still Unknown

-If there is ever a point when a QOF has failed the 90% asset test so many times that it is no longer able to be considered a QOF going forward.

-The extent of triple-net lease activity that can be engaged in while still comprising the "active conduct of a trade or business". The proposed regulations do provide that some level of triple-net lease activity is acceptable (one example indicated that buying a three-story building, leasing a story each to three separate tenants, one of which is a triple-net lease, would still overall be considered active conduct of a trade or business).

In summary, while the final regulations did not include significant changes from the two rounds of proposed regulations, they do provide a measure of certainty that may give some previously-hesitant investors the confidence to begin looking at QOFs. While a few unresolved issues remain, overall the final regulations provide a comprehensive framework for sponsors of QOFs.