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The Great and Powerful "OZ"

Finalized Regulations Released on Investing in a Qualified Opportunity Zone Fund

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Overview

After much anticipation, the Treasury Department has issued final regulations for Code Section 1400Z, Opportunity Zones. The final regulations are a lengthy 544 pages, but they clarify many open questions that investors and tax advisors had with the limited guidance previously available. The topics addressed in the final regulations include:

- **Explanations of qualified sale of property at the end of 10 years**
- **80-Day rule adjustments**
- **Section 1231 gain eligibility**
- **Changes in the substantial improvement test**
- **Vacant property rule clarification, working capital safe harbor**
- **The "sin" business de minimis exception**
- **...and more**

The Treasury Department has added much-needed flexibility to the proposed regulations, making Opportunity Zone investing more accessible and exciting than ever.

The Exit: Sale of the Opportunity Zone Property after 10 years:

Investors and tax advisors should be excited about the changes to this section. The final regulations clarify how the sale of the Qualified Opportunity Zone Fund (QOZF) or Qualified Opportunity Zone Businesses (QOZB) assets can occur and allow more options for fund managers. At the end of the entity’s life, there are four methods the QOZF and QOZB can utilize to sell their Qualified Opportunity Zone property:

- **Sale of a QOZF held by an investor**
- **Sale of a directly owned property by a QOZF**
- **Sale of an interest in a partnership, limited liability company, or stock held by a QOZF**
- **Sale of property held by a QOZB, limited liability company, or corporation in which the QOZF**

In the proposed regulations, upon sale or exchange, it seemed as though the Qualified Opportunity Zone Fund structures were going to be non-dynamic and difficult to add tiers or layers to. Now with the updated guidance, investors have more freedom when deciding to invest in a venture with multi-tier structure and still possess the power to manage one property with significant tax benefits upon the sale of the property.

There are still consequences when leaving a QOZF early or joining a QOZF late. If an investor does not meet the 10-year holding period requirement in some fashion, there is no ability to avoid the gain on the sale. However, if an investor does decide to leave the QOZF before the 10-year mark, the final regulations allow the gain to be reinvested into another QOZF, thus creating further deferral on these gains.

Sale or exchange can trigger the 180 Day rule:

In the proposed regulations, it seemed as though contributing eligible gains would only be effective when contributed on December 31st. However, the final regulations state the 180-day rule can either begin on the date of the sale or exchange of an asset or December 31st.

When examining other deferral methods, the service has given the green light to allow installment sales to be coupled with the 180-day rule allowing for two different dates of gain recognition. The investor can either recognize and measure the 180 days in the year of sale using December 31st, or they can invest their gains recognized at the same rate they are received under the installment method. This gives the investor substantial flexibility if they plan to use the installment sale method when recognizing gains for Opportunity Zone investment purposes.

The Treasury granted another investor friendly rule regarding owners of flow-through entities that encounter issues related to timing differences upon the delivery of flow-through returns. The final regulations provide flow-through entities with an option to treat the 180-day rule as beginning upon the due date of the return, not including extensions. Once more, this allows investors and tax advisors more assurance when examining timing issues related to eligible gains.

Section 1231 Gains and the 180-day Advantage:

The Treasury Department is now allowing investors to use gross Section 1231 gains to invest, rather than forcing investors to wait until the end of the year to net their Section 1231 gains and losses. If the investor uses this new method, they will net their Section 1231 gains against their Section 1231 losses at year-end, but under the final regulations, the investor would be allowed to contribute the gross gains earlier than what was previously allowed.

Using an example, if the investor has gross Section 1231 gains on June 1st, they can elect to contribute the gains on the day of the sale or exchange. Then on December 31st, the investor must calculate their Net Section 1231 gain or loss and offset the gains previously contributed to the QOZF on June 1st. Under the proposed rules (old rule) the investor would have to wait until the end of the year to contribute gains.

Substantial Improvement Test:

When examining the proposed regulations, it was apparent that the Opportunity Zone assets were evaluated on an asset by asset basis. Under the Final Regulations the Treasury Department is giving investors more options by allowing an aggregation method to determine if the QOZF meets the Substantial Improvement Test. This will not be a universal rule and investors cannot pick and choose which properties to aggregate. There will be some requirements needed to qualify, but this is a favorable rule.

One method illustrated in the regulations is as ollows. Buildings located on a single parcel of land andtransferred in a single deed will be treated as a single property regarding the substantial improvement test. The buildings or the assets must meet three requirements:

- **The buildings must be operated exclusively by the QOZF or by the QOZB**
- **The buildings must share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and**
- **The buildings must be operated in coordination with or, reliance upon one or more of the trades or business (For examples, supply chain interdependencies or mixed-used facilities)**

Vacant Property:

The new rule changes to a vacant property is another improvement, these clarify the ambiguity of the original use test and the substantial improvement test. After the rule change, if a property is vacant for at least three years prior to the purchase by the QOZF, the property will automatically meet the original use test, and this property will not be required to meet the substantial improvement test.

In addition to the three-year rule, there is another special rule that allows certain properties to be eligible for a one-year vacancy test. In order to qualify, the property must have been vacant prior to and on the date of publication of the QOZ notice that listed the designation of the QOZ in which the property is located, and through the date on which the property was purchased by an eligible entity. This is another added benefit clarified in the Final Regulations that will help provide growth for Opportunity Zone investing.

Working Capital Safe Harbor:

The adjustments to the Working Capital Safe Harbor are another investor favorable rule change. If the safe harbor is met, the QOZB can not only use the original 31-month deferral safe harbor once, but they can use it twice. This essentially allows QOZB’s up to 62 months to get their business off the ground and operating into a successful QOZF. This is an advantage for fund managers. The managers can now hold onto the start-up cash for this extended period without violating the 5% nonqualified financial asset requirement (assuming they have a written working capital plan in place).

De Minimis Exception for “Sin Businesses:”

A Qualified Opportunity Zone Business (QOZB) is required to be involved in an active trade or business to be considered an eligible investment. Certain “sin businesses” (such as golf courses, massage parlors, liquor stores, gambling facilities, etc.) are excluded from the definition of a permitted active trade or business. The Final Regulations allow these QOZB’s to have less than 5% of its property leased to a “sin business” and still qualify as an active trade or business. This carve-out could help businesses lease a portion of their property to a so-called “sin business” and still qualify as a QOZB. This was much-needed guidance as it allows investors to have more flexibility within their investments.

In conclusion:

This is just a brief summary of the key points for our clients from the information-packed regulation updates. The final regulations are indeed a lengthy read, but overall investors and fund managers should be very pleased with the Treasury Departments’ decision to release some much-needed clarification on highly debated topics. As more legislation passes, the world of QOZF’s continues to be an exciting playground for investors and tax advisors alike.

If you have questions about Opportunity Zones or Qualified Opportunity Funds, Richey May’s professionals are available to help. Please contact Stephen Vlasak for any questions regarding this summary or the public accounting services Richey May provides to the Alternative Investments industry.

To continue learning about Opportunity Zones or Qualified Opportunity Funds, visit our blog.

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