
Final Opportunity Zone Regulations Provide Some Much-Needed Clarity.

Section 1400Z-2, added by Public Law 115-97 (the Tax Cuts and Jobs Act), provides tax incentives for investors to make equity investments in qualified opportunity funds (QOFs) that will in turn invest in qualified opportunity zone business property (QOZ Business Property), either directly or indirectly through qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs).

On December 19, the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released the final regulations governing the tax benefits from investing in qualified opportunity zones (QOZs). The package is 544 pages and finalizes two different sets of proposed regulations—one issued on October 29, 2018 (October 2018 proposed regulations) and the other issued on May 1, 2019 (May 2019 proposed regulations). More than 300 comments were filed in response to the two sets of proposed regulations.

The final regulations largely finalize the rules contained in the proposed regulations and also add several new rules, many of which are taxpayer-favorable rules that had been requested by commenters. Among the new rules contained in the final regulations are rules providing: (1) "gross" 1231 gains are gains eligible for investment upon the recognition of such gains; (2) expansion of additional events involving QOF interests that are inclusion events; (3) clarification on the amount of an investor's basis in its interest in a QOF; (4) at exit, exclusion from gain for all sales of assets by a QOF or QOZ business, including hot assets but excluding inventory; (5) aggregation of the basis of assets for the substantial improvement requirement; (6) reduction of the number of years of vacancy required for property to qualify as original use; (7) expansion of the real property straddles rule to the 70% use test; (8) clarification that the working capital safe harbor can apply up to 62 months and covered tangible property qualifies as QOZ business property; (9) examples of activities that are and are not subject to the anti-abuse rule; and (10) rules providing for including QOFs in a consolidated group.

I. Provisions Relating to Initial Investment in a QOF

The final regulations made a number of changes affecting which gains are eligible for deferral under the QOZ rules.

1. Section 1231 Gains

Section 1231 gains arise when a taxpayer sells or exchanges "section 1231 property," which generally means depreciable or real property that is used in a taxpayer's trade or business and held for more than one year. Under general tax rules, a taxpayer calculates net section 1231 gain or loss at the end of the year. If there is a net section 1231 gain, all of such gains or losses are taxed at capital gains rates; if there is a net section 1231 loss, all of such gains or losses are taxed at ordinary rates.

Under the May 2019 proposed regulations, only net section 1231 gain was treated as eligible gain under the QOZ rules. As a result, a taxpayer's 180-day period for investment into a QOF did not begin until the end of the year when the amount of net section 1231 gain could be determined.

Several commenters requested that the final regulations permit a taxpayer with section 1231 gains to elect a 180-day period starting from the date of the underlying sale or exchange, rather than the end of the year. Commenters also requested that a taxpayer with net section 1231 gains for a given year be permitted to treat all section 1231 gains as eligible gains for that year.

The final regulations adopt a taxpayer-favorable "gross approach" to section 1231 gains whereby eligible gains include the gross amount of eligible section 1231 gains unreduced by section 1231 losses. Furthermore, eligible section 1231 gains are not limited to the net section 1231 gains for a taxable year. As a result, it is not necessary for an investor to wait until the end of the taxable year to determine whether any eligible section 1231 gains are eligible gains, so the final regulations start the 180-day period on the date of the sale or exchange that gives rise to the eligible section 1231 gain.

2. Gains from Sales to, or Exchanges of Property with, a QOF or QOZ Business

In general, to qualify for QOZ tax benefits, an investor must invest an eligible gain into a QOF, which requires a capital gain from the sale to an unrelated party. In addition, to qualify as QOZ Business Property, the property must be acquired by the QOF or QOZ Business by purchase from an unrelated party. As a result, neither property that is purchased by a QOF from a related party, nor property that is contributed to a QOF in a transfer under section 351 or 721 may qualify as QOZ Business Property. Commenters requested Treasury and the IRS to clarify the treatment of transactions in which a taxpayer sells property to, or exchanges property with, a QOF or a QOZ Business and then contributes the proceeds of such sale or exchange to the QOF.

The preamble to the final regulations provides some guidance on this kind of transaction. The preamble notes that generally applicable federal income tax principles may require, depending on the circumstances, that this kind of transaction be recharacterized, for tax purposes, as a contribution of the property to the QOF (potentially followed by a further contribution by the QOF to the QOZ Business). If the transaction is recharacterized in this way, then the investor generally would not be treated as investing an eligible gain, and the property generally would not be QOZ Business Property in the hands of the QOF or QOZ Business.

Because the preamble frames its analysis in terms of generally applicable federal income tax principles, such as the step transaction doctrine and circular cash flow principles, the application of these rules requires a careful analysis that takes into account all of the relevant facts and circumstances. Depending on the facts and circumstances, some sales of property to a QOF or QOZ Business followed by a contribution to the QOF may or may not be recharacterized as a contribution of property.

3. Offsetting-Positions Transactions and Straddles

The October 2018 proposed regulations included rules limiting the ability of taxpayers to treat gains from certain "offsetting-positions transactions" as eligible gains under the QOZ rules. Under the proposed regulations, these rules applied to a broader set of transactions than the existing tax rules regarding so-called "straddles." Based on concerns from commenters, the final regulations do not include the provisions that applied to offsetting-positions transactions that are not straddles and made a number of other changes to streamline and reduce the burden of these rules.

B. 180-Day Investment Period

The final regulations include a number of changes and clarifications relating to the 180-day investment period. First, as described above, the final regulations provide that the 180-day investment period for eligible section 1231 gains begins on the date of the underlying sale or exchange, rather than the end of the year.

Many investors with section 1231 gains relied on the delayed 180-day period for section 1231 gains that was included in the proposed regulations. Under the final regulations, these investors may find that the 180-day period for these gains has now expired. However, as described below, the final regulations provide that the rules contained therein are applicable for tax years beginning 60 days after the date the final regulations are published in the Federal Register. For dates prior to that time, taxpayers may choose to either rely on the final regulations or the proposed regulations, but taxpayers must choose to apply either the final or proposed regulations for each section of the regulations and cannot apply parts of both the final and proposed regulations for a particular section.

Second, the final regulations provide that the 180-day period for real estate investment trust (REIT) and regulated investment company (RIC) capital gain dividends generally begins at the close of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized. This rule is intended to facilitate the ability of RIC and REIT shareholders to make qualifying investments in QOFs even when they do not have the same taxable year as the RIC or REIT.

Third, the final regulations provide additional flexibility for qualified investment of capital gains recognized in an installment sale by allowing taxpayers to elect to choose the 180-day investment period to begin on either: (i) the date a payment under the installment sale is received, or (ii) the last day of the year the eligible gain under the installment method would otherwise be recognized.

Fourth, the final regulations modify the election for choosing a 180-day investment period for a partner's distributive share of eligible gains earned by a partnership. Under the proposed regulations, partners could elect to either use the same 180-day period as the partnership or to use the 180-day period beginning on the last day of the taxpayer's taxable year. Under the final regulations, the second option is changed to the 180-day period beginning on the due date for the partnership's tax return, without extensions. This change should provide partners with additional time to receive Schedules K-1, which provide partners with necessary information about the amount of their distributive share of eligible gain.

C. Investments By Non-US Investors

The final regulations contain a number of new rules regarding the treatment of investments into a QOF by non-US investors. The final regulations clarify that deferral of a gain generally is available only for capital gain that would otherwise be subject to US federal income tax but for the making of a valid deferral election. As a result, in order to make a qualifying investment, a non-US investor must have an eligible gain that ordinarily would be subject to US federal income tax, such as a gain that is effectively connected with a US trade or business and is not exempt from tax under an applicable income tax treaty. To prevent non-US investors from benefitting from inconsistent positions, the final regulations provide that a non-US eligible taxpayer cannot make a deferral election under the QOZ rules unless the investor irrevocably waives any treaty benefits that would exempt that gain from US federal income tax at the time of inclusion pursuant to an applicable tax treaty. Although the final regulations provide an exception to the requirement that eligible gains must otherwise be subject to US federal income tax, an anti-abuse rule prevents investors from forming or availing of a partnership with a significant purpose of avoiding the requirement.

The preamble also includes a discussion of withholding under the Foreign Investment Real Property

Tax Act (FIRPTA), which generally provides special rules for the US tax treatment of non-US persons investing in US real property. The preamble notes that commenters requested an exemption or other special rule for FIRPTA withholding on eligible gains from US real property investments that are deferred under the QOZ rules. The preamble states that Treasury and the IRS continue to consider these comments and other matters related to the mechanics of applying the QOZ rules in the context of a sale subject to FIRPTA withholding.

D. Rules for Carried Interests

The May 2019 proposed regulations provided that so-called “carried interests,” i.e., profits interests in a partnership that are received in exchange for services, must be treated as nonqualifying investments under the QOZ rules. In addition, the proposed regulations included rules for determining the “allocation percentage” of a partner’s qualifying and nonqualifying interests when a partner made a qualifying capital investment and also received a nonqualifying carried interest. Under the proposed regulations, the allocation percentage for a carried interest was “based on the highest share of residual profits” the partner would receive with respect to the carried interest.

The final regulations generally retain the treatment of carried interests from the proposed regulations. However, they modify the rule for calculating the allocation percentage for a carried interest, instead basing the percentage “on the share of residual profits the mixed-funds partner would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application.” This change appears to be intended to better capture the economics of typical private-equity waterfalls—including waterfalls where a carried interest is subject to a “catch-up” provision—while preventing partnerships from artificially lowering the percentage allocation of a carried interest by including residual allocations that do not have a reasonable likelihood of actually applying.

II. Provisions Relating to Inclusion Events

The final regulations include a number of modifications and clarifications to the rules relating to “inclusion events,” i.e., events that result in an investor recognizing all or a part of their deferred gain. For example, the final regulations clarify how the inclusion event rules for QOF C corporations, S corporations, partnerships, and trusts interact with generally applicable tax rules for these kinds of entities.

A. Additional Inclusion Events

The final regulations clarified that certain additional events beyond those listed in the May 2019 proposed regulations will be treated as inclusion events, including the loss of a QOF’s status as a QOF (either through voluntary self-decertification or involuntary decertification), an entity classification change of a QOF under the check-the-box rules (i.e., a change in tax status from a partnership to a corporation or from a corporation to a partnership), and a transfer to a spouse incident to divorce.

B. Rules for QOF C Corporations

The final regulations clarify when redemptions and distributions from C corporations, as well as corporate reorganizations, will be treated as inclusion events. With respect to redemptions, the final regulations retain the proposed rule that dividend-equivalent redemptions are inclusion events with respect to the entire amount of the distribution, with an exception for wholly owned corporations. The final regulations add an exception for pro rata redemptions if the QOF corporation has one class of stock outstanding.

With respect to distributions, the final regulations retain the rule that stock distributions described in section 305(a) are not inclusion events and clarify that the stock received in the distribution is qualifying QOF stock. In addition, the final regulations clarify that extraordinary distributions taxed as gain under section 1059(a)(2) are inclusion events.

Finally, the final regulations simplified the rules regarding reorganizations. In general, reorganizations are treated as inclusion events to the extent of any boot received, including recapitalizations and section 1036 exchanges. Under the May 2019 proposed regulations, recapitalizations and section 1036 exchanges were subject to different rules, and boot was treated differently depending on whether gain or loss was recognized.

C. Rules for QOF Partnerships

The final regulations clarify when distributions and mergers of QOF partnerships will be treated as inclusions events. However, the final regulations declined to adopt a general rule excluding divisions of QOF partnerships as inclusion events, as had been requested by some commenters. The final regulations also declined to adopt changes to the special rule for partnerships calculating the amount includible for partnerships and S corporations that commenters had requested to facilitate low-income housing tax credit investments made by QOF partnerships.

D. Rules for QOF S Corporations

The final regulations eliminate a special proposed rule from the May 2019 proposed regulations that would have treated an S corporation's qualifying investment in a QOF as disposed of if there were a greater-than-25% aggregate change in ownership of the S corporation. The final regulations further confirm that conversion from a qualified subchapter S trust (QSST) to an electing small business trust (ESBT), or vice versa, generally is not an inclusion event.

E. Basis Adjustments

The QOZ statute and May 2019 proposed regulations provided that a taxpayer's basis in its qualifying investment is increased by the amount of gain recognized in an inclusion event. The final regulations provide a number of clarifications regarding how these basis adjustments will be made, including clarifications to how these adjustments are made when a shareholder in a QOF corporation disposes of less than all of its qualifying QOF stock. Specifically, the basis adjustments are made only to the shares that are sold.

The final regulations clarify that the five-year and seven-year basis step-up for QOF partnerships and QOF S corporations will be treated as basis for all purposes, including for purposes of using suspended losses. The election to apply the 10-year basis step-up is generally not available for QOF interests with respect to which an inclusion event has occurred. However, the final regulations clarify that inclusion events resulting from distributions (e.g., under section 301(c)(3) or 731) do not preclude a subsequent 10-year basis step-up, as long as the investor continues to own the QOF interests.

The preamble states that Treasury and the IRS have determined that the section 1014 basis step-up upon death does not apply to adjust the basis of an inherited qualifying investment to its market value as of the deceased owner's death (though it does apply to the basis of non-qualifying investments). This rule will complicate estate planning for QOF investors.

F. Applicable Tax Rate

The final regulations clarify that gain recognized in an inclusion event is subject to taxation at the applicable federal income tax rates for the year of inclusion, not the year of deferral.

III. Provisions Relating to Exit

The QOZ statute anticipated that investors will exit from an investment in a QOF by selling their interest in the QOF. However, this is not how exits from an investment fund are typically structured. Instead, the typical investment fund disposes of all or a portion of its assets (either by selling equity interests in a portfolio company or causing the portfolio company to sell its assets) and distributes the proceeds to its investors.

Recognizing this, the May 2019 proposed regulations provided some flexibility to structure exits as sales at the QOF level. The proposed regulations provided relief by allowing a QOF investor who has held its investment in a QOF for at least 10 years to make an election to exclude from gross income capital gain from the sale or disposition of QOZ Property by the QOF that is reported on the investor's Schedule K-1 (the "K-1 Rule"). Just as important, the K-1 Rule preserved the investor's increase in the basis of its QOF interest from such gain, which would prevent a subsequent distribution of the sales proceeds from generating additional gain to the investor.

The May 2019 proposed regulations also mitigated the potential negative consequences of the so-called "hot asset" rules. In general, the hot asset rules require recognition of ordinary income instead of capital gain upon the sale of a partner's interest to the extent the amount received is attributable to hot assets of the partnership. Hot assets are generally assets of a partnership that would generate ordinary income, including inventory, unrealized receivables, and depreciation recapture. Under the QOZ statute, there was a concern that, even if there would be no gain on exit from a QOF partnership in the absence of the hot asset rules, an investor still would recognize its share of ordinary income on any hot asset and would be deemed to have an offsetting capital loss. The application of the hot asset rules to the sale of a QOF interest or QOZ Property could undermine the benefit of the 10-year basis step-up rule, because many taxpayers cannot make current use of the offsetting capital loss, effectively leaving them with full or partial inclusion of the 10-year appreciation. The May 2019 proposed regulations addressed this issue by providing that, when an investor sells a qualifying investment in a QOF partnership after the 10-year holding period, a special deemed adjustment is made to the inside basis of QOF partnership assets immediately before the sale so as to mimic a cash purchase of the investment when a section 754 election is in effect, with the result that ordinary income is not triggered (the "Deemed Section 754 Election").

However, several significant questions remained unanswered, including: (1) how sales of property by QOZ Businesses after the 10-year holding period are treated under the K-1 Rule; (2) whether the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZ Business level; and (3) whether ordinary income from hot assets sold by the QOF or QOZ Business could be excluded by the investor under either the K-1 Rule or the Deemed Section 754 Election.

In addition, the May 2019 proposed regulations provided that, when a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z-2(c), the basis of the partnership interest is adjusted to an "amount equal to the fair market value of the interest, including debt." Commenters also requested that the final regulations clarify that the phrase "including debt" in results in a step-up in basis of the full amount realized by an investor (including the investor's share of partnership debts) so that no gain or loss would be recognized on exit based upon a reduction in an investor's share of partnership debt.

The changes in the final regulations appear to address many of the recommendations made by commenters seeking to improve the flexibility of investors and QOFs to structure exits from investments after 10 years without reducing or eliminating QOZ tax benefits.

A. Expansion of Proposed Rules for Asset Sales by QOFs and QOZ Businesses

The final regulations significantly expand the proposed rules for gain exclusion for asset sales by QOFs and QOZ Businesses. In particular, the final regulations permit a taxpayer that invests in a QOF partnership or QOF S corporation to make an election for each taxable year to exclude a QOF's gains and losses from all sales or exchanges in the taxable year, rather than just capital gains or losses. The only exception is for gains or losses from the sale of inventory by the QOF in the ordinary course of business.

This expanded rule generally should permit investors in a QOF partnership or QOF S corporation to structure exits as asset sales at the QOZ Business level without reducing the benefit of the 10-year basis step-up. In addition, this expanded rule generally should prevent the hot-asset rules from reducing the QOZ tax benefits for exits structured in this way.

In order to prevent the duplication of the tax benefits provided by the 10-year basis step-up, the final regulations treat—solely for the purposes of determining the amount of an investor's qualifying investment and non-qualifying investment—QOFs and investors electing to take advantage of this rule as making a deemed distribution and recontribution of net proceeds from the asset sales on the last day of the QOF's taxable year.

B. Clarification and Enhancement of Deemed Section 754 Election

The final regulations also clarify that the Deemed Section 754 Election generally applies to the sale of a QOF interest even with respect to hot assets held at the QOZ Business level. Furthermore, the preamble states that the 10-year basis step-up "is designed to result in no gain or loss to the transferor QOF partner." To ensure this result, the final regulations provide that, to the extent existing rules for basis adjustments operate in a manner that results in recognition of gain or loss on a sale of a QOF partnership interest after 10-years, basis adjustments will be made to the extent necessary to eliminate any such gain or loss.

C. Clarification of "Including Debt"

The final regulations include a rule that more clearly states that the basis of a QOF partnership interest will be adjusted to an amount equal to the net fair market value of the interest, plus the partner's share of partnership debt. This clarification should prevent a reduction in an investor's share of partnership debt upon selling a QOF partnership interest from reducing the QOZ tax benefits provided by the 10-year basis step-up.

D. Exits After December 31, 2047

The October 2018 proposed regulations preserved the ability of taxpayers to make an election under the 10-year basis step-up rule until December 31, 2047. Although the final regulations do not make any changes to this rule, the preamble notes that Treasury and the IRS will continue to consider whether an automatic basis-step up to fair market value should be made immediately before the end of 2047 if a QOF interest is not sold and how best to value investments absent a sale to an unrelated person.

IV. Provisions Relating to QOF Requirements

A. Certification

The final regulations generally retain the rules for self-certification of a QOF from the proposed regulations. In particular, the final regulations do not adopt recommendations to require fund managers or sponsors to make a “clean hands” certification or to provide anti-abuse safe harbors for QOFs that apply for and receive an independent third-party certification. The preamble explains that Treasury and the IRS considered a variety of suggestions from commenters to make the certification process more robust but believed that the proposed regulations strike an appropriate balance between providing taxpayers with a flexible and efficient process for organizing QOFs, while ensuring that investments in such vehicles will be properly directed toward the economic development of low-income communities.

B. Decertification

The October 2018 proposed regulations announced an intention to publish additional guidance regarding QOF decertification. The final regulations include a voluntary self-decertification process. Furthermore, the preamble states that Treasury and the IRS continue to consider the circumstances under which involuntary decertification of a QOF would be warranted, but the final regulations themselves reserve on this issue. However, the final regulations provide an example under the anti-abuse rule that recharacterizes an entity as not a QOF if it fails the 90% test year after year. This is effectively a decertification.

C. 90 Percent Investment Standard

The QOZ statute provides that a QOF must maintain an average of 90% of its assets in QOZ property, measured on specified semiannual testing dates. The proposed regulation provided that, to meet this 90% investment standard, a QOF may value its assets on a semiannual basis using (i) the values listed on an applicable financial statement (AFS) if the QOF has one, or (ii) an alternative valuation method based on the basis of assets.

The final regulations clarify that a QOF may determine whether the 90% investment standard is satisfied by valuing its assets on the semiannual testing dates specified in the statute. In addition, the final regulations provide that the alternative valuation method may be used to value only assets owned by a QOF that are acquired by purchase or constructed for fair market value. The final regulations also provide some clarifications to the rules for valuing leased property.

The final regulations generally retain the proposed rules permitting a QOF to disregard recently contributed property for purposes of the 90% investment standard, expressly rejecting any change to avoid an undefined mathematical result if all of the QOF’s property were being disregarded under this rule. The final regulations provide that a QOF has until the fifth business day after a contribution of property to exchange such property into cash, cash equivalents, or short-term debt in order to qualify for the rules. Treasury and the IRS declined to adopt recommendations to expand this rule from six months to 12 months, at least during a QOF’s initial start-up period, and also declined to adopt recommendations to provide a wind-down period safe harbor for applying the 90% investment standard.

V. Provisions Relating to QOZ Business Property Requirements

1. Buildings

The final regulations provide aggregation rules for the substantial improvement requirement. Buildings on a single deeded property may be treated as a single property. Buildings on contiguous parcels of land may be treated as a single property as long as they are:

- Operated exclusively by the QOF or QOZ Business,
- Share business resource elements (e.g., accounting or other back office functions) or employees, and
- Are operated in coordination with one or more of the trades or businesses (e.g., supply chain interdependencies or mixed-use facilities).

For two or more buildings treated as a single property, the amount of basis required to be added will be the total basis of each building.

2. Operating Assets

With respect to other assets, the aggregation rules look at the functionality of the aggregated assets. The cost of purchased property that qualifies as QOZ Business Property (i.e., original use property) may be added to the basis of purchased non-original use assets to meet the substantial improvement requirement for the non-original use assets, if the original use property:

- Is used in the same trade or business in the QOZ (or contiguous QOZ) in which the non-original use asset is used, and
- It improves the functionality of the non-original use asset in the same QOZ or contiguous QOZ.

The final regulations provide an example of a QOF that purchases an existing, non-original use hotel. The QOF may count the basis of purchased original use items such as mattresses, gym equipment, and furniture as well as renovations of the in-hotel restaurant towards the substantial improvement of the hotel property. However, improvements made to an apartment building that is not used in conjunction with the hotel do not count towards the substantial improvement of the hotel.

The final regulations also clarify that any costs that are added to the basis of property will count for purposes of substantial improvement, including equipment installed in a building, demolition costs, capitalized fees for development, required permits, necessary infrastructure, brownfield site remediation, professional fees, and site preparation costs.

3. Land

The final regulations retain the rule that land is not required to be substantially improved. However, the regulations also retain the rule that land should be improved by more than an insubstantial amount. Treasury and the IRS declined to assign a specific percentage for “more than insubstantial” because it is a fact intensive inquiry. When applying the functionality aggregation rule to non-original use land, the original use property must improve the land by a more than insubstantial amount.

Improvements to the land, including grading, clearing of the land, remediation of contaminated land, or acquisition of related QOZ Business Property that facilitates the use of the land in a trade or business of the eligible entity, will be taken into account in determining whether the land was improved by more than an insubstantial amount. The preamble gives an example of an irrigation system for a farming business that is more than an insubstantial amount of improvement.

4. Substantial Improvement Period

The final regulations clarify that during the 30-month substantial improvement period, property in the process of being improved is treated as meeting the substantial improvement requirement for the 90% asset test.

B. Self-Constructed Property

In general, the QOZ statute requires tangible property owned by a QOF or QOZ Business to have been acquired by purchase from an unrelated party after December 31, 2017. Prior to the issuance of the final regulations, it was unclear how this rule was meant to apply to self-constructed property.

The final regulations include rules for self-constructed property similar to those previously adopted under section 168. Treasury and the IRS concluded that tangible property is not disqualified from constituting QOZ Business Property solely because it is manufactured, constructed, or produced, rather than purchased, by a QOF or QOZ Business. However, to qualify as QOZ Business Property, the property must be constructed with the intent to use the property in a trade or business in a QOZ, and the materials and supplies used in construction must be QOZ Business Property.

The final regulations also provide rules for determining the date on which self-constructed property is treated as purchased. The final regulations provide that self-constructed property will be treated as acquired on the date physical work of a significant nature begins. Physical work of a significant nature does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The final regulations provide a safe harbor under which a QOF or QOZ Business may choose the date on which it paid or incurred more than 10% of the total cost of the property—excluding the cost of any land and preliminary activities.

C. Original Use Requirement

1. No Rule for "Overwhelmingly Improved" Property

The preamble to the May 2019 proposed regulations noted that Treasury is studying circumstances under which property has not been purchased but has been "overwhelmingly improved" by a QOF or a QOZ Business may be treated as satisfying the original use requirement. Commenters recommended that Treasury consider adopting a rule similar to the so-called "80-20 Rule" from renewable energy tax credit guidance for this purpose. In particular, commenters recommended that tangible property owned by a QOF or QOZ Business should be treated as QOZ Business Property meeting the purchase and original use requirements even though it incorporates some nonqualifying property, provided the fair market value of such nonqualifying property is not more than 20% of the tangible property's total value (the additions to basis of the new property plus the value of the nonqualifying property). However, Treasury and the IRS declined to adopt any rules permitting overwhelmingly improved property to be treated as satisfying the original use requirement.

2. Newly Constructed Buildings

Commenters sought clarity that a building that was newly constructed and purchased by the QOF or QOZ Business prior to being placed in service in the QOZ would satisfy the original use requirement. The final regulations add an example clarifying this.

3. Vacant Property and Brownfield Sites

The May 2019 proposed regulations provided that, where a building or other structure has been vacant for at least five years prior to being purchased by a QOF or QOZ Business, the purchased building or structure will satisfy the original use requirement. The final regulations make several taxpayer-favorable changes to this proposed rule. First, with respect to property that was vacant on the designation date of a QOZ through the date on which the QOF or QOZ Business purchased the property, only a one-year vacancy period will be required. Second, a three-year vacancy period is required for property that was not vacant at the time of the QOZ designation. Third, the final regulations provide that real property is considered to be vacant if it is "significantly unused." A building or land will be considered significantly unused if more than 80% of the square footage of usable space is not being used. Fourth, the final regulations provide that a QOF or QOZ Business that purchases real property from a local government that the local government holds as the result of an involuntary transfer (including through abandonment, bankruptcy, foreclosure, or receivership) may treat all property composing the real property (including the land and structures thereon) as satisfying the original use requirement.

The final regulations also provide special rules for buildings located on "brownfield sites" under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). In particular, the final regulations provide that all real property composing a brownfield site, including land and structures located thereon, will be treated as satisfying the original use requirement. The QOF or QOZ Business must make investments in the brownfield site to ensure that the site meets basic safety standards for human health and environment.

D. Rules for Leased Property

The final regulations include some modifications to the proposed rules for leased tangible property. For example, the final regulations exempt State and local government, as well as Indian tribal governments, from the market-rate requirement for leased tangible property. The final regulations also include a rebuttable presumption that leases between unrelated parties satisfy the market-rate requirement. The final regulations also contain additional examples to clarify the application of the leased property rules.

E. Inventory

The final regulations include several taxpayer-favorable changes to the rules for inventory. First, the final regulations extend the rule that permits QOFs or QOZ Businesses to treat inventory in transit as used in the QOZ for purposes of the substantially all of the use requirement to the 90% investment standard at the QOF level and the 70% assets test at the QOZ Business level. For purposes of these tests, the final regulations provide that a QOF or QOZ Business may choose to either: (i) include inventory in both the numerator and denominator; or (ii) exclude inventory entirely from both the numerator and denominator. In addition, the final regulations clarify that the distance traveled in the course of transit and the fact that inventory is briefly warehoused while in transit will not affect the application of the inventory transit safe harbor included in the May 2019 proposed regulations. Finally, the final regulations provide that inventory is deemed to satisfy the original use and substantial improvement requirements.

F. "Substantially All" Requirements

1. 70 and 90 Percent Thresholds

The final regulations retain the 70% and 90% thresholds established by the May 2019 proposed regulations for the various "substantially all" requirements in the QOZ statute. Treasury and the IRS specifically rejected comments to increase the 70% threshold to 90%, because they believed that the 70% standard achieves an appropriate balance between providing proper flexibility to potential investors in QOZs and limiting the potential for abuse. They also rejected comments to adopt a higher threshold for real estate, because different rules for different businesses would be burdensome.

The final regulations added specific rules clarifying the application of the 70% use test. The final regulations provide that use of tangible property in a trade or business is determined based on the amount of time during which the property is (i) located within the geographic borders of a QOZ, and (ii) in connection with the ordinary conduct of the trade or business, utilized in the QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business.

For mobile tangible property, the final regulations provide a couple of safe harbors, which are intended to strike an appropriate balance between allowing flexibility for business development and ensuring that such business development primarily benefits low-income communities in QOZs. One safe harbor permits up to 20% of the tangible property of a trade or business to be treated as satisfying the 70% tangible property standard if (i) the tangible property is utilized in activities both inside and outside of the QOZ, (ii) the trade or business has an office or other fixed location located within a QOZ, (iii) the tangible property is operated by employees of the trade or business who regularly use the office and are actively managed by one or more employees at the office, and (iv) the tangible property must not be operated exclusively outside of the geographic borders of a QOZ for a period longer than 14 consecutive days. A second safe harbor is provided for short-term leases of tangible property by a trade or business located within the QOZ to a lessee that utilizes the tangible property outside of a QOZ, if (i) the tangible property is parked or otherwise stored at a location within a QOZ when the tangible property is not subject to a lease, and (ii) the lease duration (including any extensions) must not exceed 30 consecutive days.

The final regulations also clarify that the 70% use test is determined on an aggregate basis when tangible property is used in multiple QOZs. However, Treasury and the IRS declined to adopt recommendations to add a separate 90% threshold for the location of real property.

2. 90-Percent Holding Periods

The final regulations provide that the determination of whether the 90% holding period requirement is satisfied is made on a semiannual basis, based on the cumulative amount of time the QOF or QOZ Business has held the property. Similarly, stock or partnership interests will satisfy the 90% holding period requirement if during 90% of the QOF's holding period for the stock or partnership interest, beginning on the date that its self-certification as a QOF is effective and ending on the relevant semiannual testing date, the corporation or partnership qualified as a QOZ Business. The final regulations acknowledge that taxpayers may encounter difficulties when a QOF's semiannual testing date falls before the end of the entity's taxable year and provide a safe harbor testing period that starts with the beginning of the QOF's status as a QOF and lasts until the last day of the entity's latest taxable year and ends on or before the relevant testing date.

3. Cure Period for QOF Investing in an Entity that Fails to Meet QOZ Business Requirements

Commenters noted that, under the proposed regulations, no relief was available to a QOF that discovered that the entity in which it invested failed to qualify as a QOZ Business. In response to these comments, the final regulations adopt a six-month cure period for an entity in which a QOF has invested to cure a defect that caused the entity to fail to qualify as a QOZ Business. The preamble notes that, in addition to this six-month cure period, a QOF can assert a defense of reasonable cause if the QOF becomes subject to a penalty for failure to satisfy the 90% investment standard.

G. Real Property Straddles

The final regulations expanded the real property straddling rule to be applicable for determining whether property qualifies as QOZ Business Property. The May 2019 proposed regulations only applied this rule for the safe harbors of the gross income test. The final regulations provide that real property that straddles contiguous QOZ and non-QOZ tracts and is substantially located in a QOZ tract qualifies for purposes of the 70% use test. Property is treated as substantially within a QOZ if the amount of property within the QOZ is greater than the amount of the property located in the non-QOZ tract. The final regulations provide that for purposes of determining whether property is substantially located within a QOZ, the QOF or QOZ business may use either the square footage or the unadjusted cost basis of the property.

H. "Sponsor-Like" Arrangements

The final regulations added rules to address the qualification of property purchased in certain "sponsor-like" arrangements as QOZ Business Property. In particular, the final regulations provide that, in the case of real property that is purchased by a QOF or QOZ Business, if at the time of the purchase there was a plan, intent, or expectation for the real property to be repurchased by the seller of the real property for an amount of consideration other than the fair market value of the real property, the purchased real property is not QOZ Business Property. Under this rule, the "fair market value of the real property" refers to the fair market value of that property at the time of the repurchase by the seller. It is unclear how this rule will apply to situations where there is a plan to repurchase real property based on a formula that is intended to act as a proxy for fair market value, such as a repurchase at a multiple of a specified financial ratio.

VI. Provisions Relating to QOZ Business Requirements

A. Gross Income Test

Commenters requested clarification that the gross income test could be met through income arising from more than one QOZ. Consistent with this, the final regulations include rules to aggregate the income from activities in all QOZs for purposes of meeting the gross income test.

Commenters also requested that Treasury apply the gross income test to activities conducted directly as the QOF level. Treasury and the IRS declined to do so, noting that the section 1397C requirements apply only at the QOZ Business level.

For the safe harbors of the gross income test that look to the performance of services or amounts paid, the final regulations provide that hours worked by or amounts paid to a partner of the partnership qualify to the extent the amounts paid would constitute guaranteed payments within the meaning of section 707(c).

B. Intangible Property

The final regulations provide clarification on meeting requirements for the use of intangible property. Intangible property will be treated as used in the active conduct of a trade or business if:

The use of the intangible property is normal, usual, or customary in the conduct of the trade or business, and
The intangible property is used in the QOZ in the performance of an activity of the trade or business that generates gross income for the business.

C. Working Capital Safe Harbor

While the May 2019 proposed regulations permitted multiple, overlapping 31-month safe harbor periods, it was not clear whether the QOZ Business was required to be engaged in an active trade or business at the end of the first 31-month period. This lack of clarity presented issues for start-up businesses as well as for very large, transformational projects

The final regulations retain the rule from the May 2019 proposed regulations that a single business can have multiple sequential or overlapping 31-month safe harbor periods. However, the final regulations provide that a single unit of tangible property may only benefit from two such periods for a total of 62 months. Tangible property that is purchased, leased, or improved during this 62-month period will count towards the 70% tangible property test, and intangible property purchased or licensed during that period will count towards the 40% intangible property use test.

The May 2019 proposed regulations provided for an allowable delay in meeting the working capital safe harbor resulting from waiting for government action on a permit application. Commenters requested an expansion of the events that can delay meeting the working capital safe harbor to other events outside of the taxpayer's control. The final regulations provided a modest expansion of the scope of events that will delay the safe harbor. If the QOZ business is located in a QOZ designated as part of a federally declared disaster area, the QOZ business may receive an additional 24 months to consume its working capital assets.

D. Active Conduct

The May 2019 proposed regulations provided that "merely" entering into a triple-net lease is not the conduct of an active trade or business. Commenters requested clarification as to whether any activity involving triple-net leases may rise to the level of an active trade or business. The final regulations provide an example showing that a business can have some activity with triple net leases and still be an active trade or business. The example demonstrates that having one triple net lease and other active leases will not disqualify a business. However, the regulations do not answer the question of whether multiple triple-net leases may rise to the level of a trade or business.

E. Sin Businesses

Commenters recommended that final regulations provide that sin businesses may not be operated directly by QOFs. Treasury and the IRS declined to adopt this recommendation, noting that the statutory language is explicit in prohibiting QOZ Businesses from operating sin businesses, but does not prevent operation of sin businesses by QOFs. The final regulations do adopt recommendations to prevent businesses from leasing to sin businesses as well as recommendations to adopt a de minimis exception, providing that a QOZ Business cannot lease more than five percent of its real property to a sin business.

F. Investment in Subsidiaries

Commenters requested an exception to the non-qualified financial property limitation to allow QOZ Businesses to hold interests in subsidiary businesses. Treasury and the IRS declined to adopt this recommendation, noting that the statutory definition of non-qualified financial property explicitly includes stock and partnership interests.

VII. Provisions Relating to the 90 Percent Penalty and Anti-Abuse Rules

A. 90 Percent Test Penalty

If a QOF fails to meet the 90% asset test, the QOF must pay the penalty described in section 1400Z-2(f) for each month that it fails to meet the 90% test, subject to a reasonable cause exception. Commenters requested Treasury to provide factors to consider in determining whether a QOF has reasonable cause for failure to meet the 90% test. Treasury and the IRS declined to do so, reasoning that there are appropriate standards for reasonable cause in Internal Revenue Manual section 20.1. Treasury will consider whether guidance on the 90% penalty or the reasonable cause exception is necessary in the future.

B. Anti-Abuse Rules

Commenters requested that Treasury provide a statement of the general purpose of section 1400Z-2 and examples to illustrate what behavior is considered abusive and not abusive. The final regulations provide such a statement—that the purposes of the statute of encouraging making longer-term investment of new capital into QOZs and increasing the economic growth of QOZs. The preamble to the regulations states that holding land for speculative purposes does not further the purposes of section 1400Z-2.

The final regulations also provide several examples to illustrate the anti-abuse rule. To illustrate the level of improvement needed for land, the following examples are provided:

- A parking lot and small structures are constructed on land. This is subject to the anti-abuse rule and constitutes a speculative investment activity in land.
- Farmland is acquired with a significant investment of capital and labor to convert from pig and hog farming into goat and sheep farming. This is a sufficient QOZ business and is not subject to the anti-abuse rule.

The final regulations also add an anti-abuse rule for using partnerships to create eligible gains and circumvent the rule that eligible gains must be subject to income tax. This rule provides an example of a partner not subject to tax contributing property to partnership to have the partnership make the deferral election. This is deemed to violate the anti-abuse rule and the partnership is disregarded for purposes of the statute.

Treasury and the IRS declined to follow recommendations to provide a good faith safe harbor from the anti-abuse rule, reasoning that the purposes of section 1400Z-2 are not so “elusive” that a good faith attempt to comply with the rules could be subject to the anti-abuse rule. Treasury and the IRS also declined to adopt an independent certification standard.

Commenters requested that Treasury implement a robust reporting regime. In the preamble, Treasury and the IRS noted that reporting was outside of the scope of these regulations but will continue to be studied. We note that the IRS updated its forms to make them more robust. Form 8996, Qualified Opportunity Fund, must be filed by QOFs, and Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, must be filed by investors. The regulations did add a “penalty” for failure to file Form 8997 relating to how much deferred gain remains deferred, in the form of a rebuttable presumption that the investor suffered an inclusion event.

VIII. Provisions Relating to Consolidated Groups

The May 2019 proposed regulations declined to permit a QOF C corporation to be a subsidiary member of a consolidated group, although it could be a common parent. This was because Treasury and the IRS believed that the consolidated return regulations are incompatible in many respects with the rules of section 1400Z-2, and special rules would be necessary to harmonize them. In response to comments, the final regulations allow subsidiary QOF C corporations to join in the filing of consolidated returns, and the regulations provide rules to harmonize the consolidated return and QOZ rules. The consolidated group member that makes the direct investment in the QOF member must generally maintain a direct equity investment in the QOF, and all QOF investor members must be wholly owned, directly or indirectly, by the common parent of the consolidated group. The final regulations also provide that the basis rules of section 1400Z-2 generally trump the basis adjustment rules of Treas. Reg. § 1.1502-32. To deal with negative basis issues, the final rules provide that the investor member must take into account its excess loss account pursuant to Treas. Reg. § 1.1502-19 before its basis in the QOF member stock is adjusted to fair market value under section 1400Z-2(c). The final regulations also provide rules regarding the deconsolidation of QOF members.

Under the May 2019 proposed regulations, the requirements in section 1400Z-2 applied separately to each member of a consolidated group. Thus, the same member of the consolidated group must both sell the capital asset giving rise to eligible gain and timely invest the proceeds in a qualifying investment. In response to comments, the final regulations include an election to treat the investment by one member as a qualifying investment by another member. If the consolidated group makes this election, for all Federal income tax purposes, the first member is treated as making an investment in the QOF and immediately selling the qualifying investment to the second member for fair market value, subject to the rules of Treas. Reg. § 1.1502-13.

IX. Applicability Dates and Effective Dates

The final regulations provide that the rules contained therein are applicable for tax years beginning 60 days after the date the final regulations are published in the Federal Register.[1] For dates prior to that time, taxpayers may choose to either rely on the final regulations or the proposed regulations, but taxpayers must choose to apply either the final or proposed regulations for each section of the regulations and cannot apply parts of both the final and proposed regulations for a particular section.

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