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## Final Tax Regulations Offer More Certainty to Opportunity Zone Fund Managers and Investors: Orrick

Opportunity Zone (or "OZ") investment was hailed in 2018 and 2019 as the hottest and most innovative way of attracting significant private capital to distressed communities in the United States and its territories by offering significant tax deferrals, reductions and exclusions to investors with capital gains willing to make these investments. Despite its promise, OZ investment stalled in 2018 and 2019 due to significant uncertainty over how the generous tax incentives enacted by Congress under the December 2017 Tax Cuts and Jobs Act would be implemented by the U.S. Internal Revenue Service ("IRS"). The Final Regulations issued by the IRS on December 18, 2019 (the "Final Regulations"), have addressed many areas of major concern for managers of a "qualified opportunity fund" ("QOF") and investors in those QOFs, opening the door for many more opportunities for these tax-advantaged investments. The Final Regulations are effective for tax years beginning after March 13, 2020 (but an election may be made to apply the Final Regulations retroactively, which likely will be applied in most cases). Where early application of the Final Regulations is not elected and prior to effectiveness of the Final Regulations, the rules applicable to OZ investment continue to be those under the regulations proposed by Treasury and the IRS on October 29, 2018 and May 1, 2019 (the "Proposed Regulations").

Orrick's November 2018 client alert on Opportunity Zones and Qualified Opportunity Funds Accelerating U.S. Community Impact Financing sets forth the key elements of the tax benefits provided by investment in Opportunity Zones. In large part, these key elements remain unchanged:

- WHAT ARE OPPORTUNITY ZONES: Qualified Opportunity Zones ("QOZ") are approximately 8,700 low-income census tracts, and areas contiguous to such tracts, throughout the United States and its territories that were selected by the chief executive (e.g., governor) of each state or territory and confirmed by the IRS. These will not change without an act of Congress.
- WHO IS ELIGIBLE TO RECEIVE TAX BENEFITS: Any U.S. taxpayer who invests capital gains in a QOF and elects to receive OZ tax benefits with respect to its investment.
- WHAT ARE THE TAX BENEFITS: Three types are offered by the OZ program: (1) the deferral of tax on capital gain being contributed as equity to a QOF, until 2026; (2) increase in basis related to a QOF interest, resulting in exclusion of a portion of capital gain from deferred tax; and (3) a further increase in basis related to a QOF interest, so as to exclude gain on a QOF interest if held for at least 10 years.
- WHAT IS A QOF REQUIRED TO DO: A QOF, organized as a corporation or a partnership, must meet a test (the "QOF 90% Test") each six months that requires the QOF to hold 90% of its assets in equity of a Qualified Opportunity Zone Business ("QOZB") or a Qualified Opportunity Zone Property ("QOZP"); QOZBs in turn must hold substantially all of their tangible property (i.e., 70%) as Qualified Opportunity Zone Business Property ("QOZB Property"). The QOF 90% Test has many technical aspects that led to confusion and uncertainty and resulted in hundreds of comments to the October 2018 and May 2019 Proposed Regulations that preceded the Final Regulations, and much of the 500 pages of the Final Regulations appear to be aimed at allowing for more flexible application of the QOF 90% Test. Failure to meet the QOF 90% Test for any six-month period can lead to a penalty being assessed on the QOF (and each partner in a QOF where the QOF is

organized as a partnership) equal to the deficiency multiplied by the IRS's underpayment penalty rate, unless the QOF can show the failure was due to reasonable cause (i.e., factors beyond its control, such as delays in required government approvals).

**The Final Regulations**

The Final Regulations are divided into six parts, corresponding with operative sections of the Internal Revenue Code: (1) Regulation Section 1.1400Z2(a)-1 deals with the procedure for deferring gains and sets forth the operative definitions; (2) Regulation Section 1.1400Z2(b)-1 deals with the inclusion of gains that have been deferred; (3) Regulation Section 1.1400Z2(c)-1 deals with issues associated with QOF investments that have been held for at least 10 years and that are eligible for the tax exemption; (4) Regulation Section 1.1400Z2(c)-1 sets forth the requirements for QOZP; (5) Regulation Section 1.1400Z2(d)-2 sets forth the QOZB Property requirements; and (6) Regulation Section 1.1400Z2f)-1 deals with the reinvestment of proceeds and establishes a number of anti-abuse rules.

The focus of this Client Alert is certain of the changes introduced by the Final Regulations, which serve to encourage investment in operating businesses and commingled funds, arguably the areas which hold the most promise for positively impacting existing communities in the Opportunity Zones.

**Changes and Clarifications Introduced by the Final Regulations**

***Better Rules for Operating Businesses***

More Flexible Qualifying Rules for QOZBs: QOF investment in operating businesses are expected to be through QOZBs. By way of review, a QOZB is a trade or business that meets each of the following requirements:

- Substantially all (i.e., at least 70%) of the tangible property owned or leased in connection with the trade or business must be QOZB Property (this 70% requirement provides an incentive for QOFs to invest in QOZBs rather than directly into QOZP, because all of a QOF's investment in QOZP must otherwise qualify (not just 70%)). Under the Final Regulations, leased property can now qualify as QOZB Property if entered into at market rental rates (unless the lessor is a state, city or tribal nation where market rates are not required) and valued as set forth in the Final Regulations.
- Tangible property held in connection with a QOZB must either be "original use" or if not original use, "substantially improved" (i.e., improvements equal in value to the tax basis of the tangible property must be made by the QOZB). Under the Final Regulations, (i) this "substantial improvement" test can now be satisfied on an aggregate basis rather than on an asset-by-asset basis if the assets are in the same QOZ, are used in the same trade or business and they improve the functionality of the property to be improved, and (ii) brownfields and vacant land (i.e., land vacant for at least one year) are generally exempted from the "substantial improvement" test and treated as original use, except property that becomes vacant in a designated QOZ must be vacant for three years in order to be treated as original-use property. This loosening of the substantial improvement rules provides greater certainty to a wider variety of operating businesses, both as to how to measure substantial improvement and how to manage abandoned lots.
- The QOZB must satisfy certain operating tests, set forth below, all of which were loosened under the Final Regulations.

(i) First, at least 50% of the total gross income of the QOZB must be derived from the active conduct of the trade or business in the QOZ. Under the Final Regulations, (i) this test can be satisfied based on where employees (which now includes independent contractors) are located (based on hours worked or compensation), based on the location of management and key tangible assets used in the business or based on facts and circumstances, all of which invite a wider range of businesses (operating business, start-up businesses, manufacturing businesses, tech businesses and others) to be able to be capitalized with OZ investment.

(ii) Second, a substantial portion (i.e., at least 40%) of the intangible property of the QOZB must be used in the active conduct of the trade or business in the QOZ. According to the Final Regulations, intangible property is treated as used in an active trade or business if the use is normal, usual or customary in the conduct of the trade or business and the intangible property is used in the OZ in the business to contribute to the generation of gross income for the business. There may be uncertainty about the application of these principles in specific situations.

(iii) Third, less than 5% of the average of the aggregate unadjusted bases of the property of the QOZB must be attributable to nonqualified financial property (e.g., cash and cash equivalents). The Proposed Regulations provided a safe-harbor to allowing capital contributed to the QOZB to be spent to develop a property over a period of 31 months, as long as there is a written plan and schedule in place for deploying the capital and the capital is actually used in a manner substantially consistent with the plan and schedule. The Final Regulations clarify that the 31-month spending period can be applied to a start-up operating business and provide that this period can be extended to 62 months if there are multiple tranches of capital contributions to the QOZB.

- The QOZB cannot be a so-called "sin business," such as massage parlors, tanning salons, tattoo parlors, liquor stores and golf courses, except that the Final Regulations permit a QOZB to have a small portion of its assets (i.e., less than 5%) in such businesses as part of a larger development, such as a liquor store that is part of a larger shopping mall or a tanning salon that is part of a hotel's spa facilities.

***Better Rules for Commingled Funds and Multi-Tiered Investment***

*Sales of Property by Individual QOZBs.* Under the Proposed Regulations, a QOF investor could only elect after a 10-year holding period to exclude gains from the sale of qualifying investments or capital gain property sold by a QOF operating in partnership or S corporation form, but not property sold by its QOZB. This approach had a chilling effect on the formation of commingled funds that are invested in multiple properties or businesses, because it was very hard to plan a tax-free exit by the QOF for multiple assets at the same time in the future. The Final Regulations provide that capital gains from the sale of property by a QOZB that is held by such a QOF may also be excluded from income as long as the investor's qualifying investment in the QOF has been held for 10 years. In such event, the amount of gain from such QOFs or its QOZB's asset sales that an investor in the QOF may elect to exclude each year will reduce the amount of the investor's interest in the QOF that remains a qualifying QOF investment eligible for further QOF tax benefits.

*Disposition by QOF Investors of Stakes in Multi-Asset Funds.* As noted above, the rule of the Proposed Regulations made the tax exemption available only upon disposition by a QOF after the 10-year holding period. However, in a typical sale by a QOF, a portion of the gain would not be capital gain and thereby would potentially reduce the QOZ tax benefits as compared to a sale by the QOF investor of its interests in the QOF which often led to structuring issues for a QOF with multiple properties or QOZBs. The Final Regulations significantly expand the proposed rules by providing for gain exclusion for asset sales. In particular, the Final Regulations permit a taxpayer that invests in a QOF partnership or 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. Thus, the Final Regulations more closely align the QOZ tax benefits on a sale by a QOF with the benefits on a sale by the QOF investor of its interests in the QOF, thereby providing more flexibility for multi-asset QOFs to sell underlying assets, businesses and real estate projects.

*Distributions.* The Final Regulations also clarify that certain distributions by a QOF to its investors may qualify for the exemption, and certain interim distributions offered prior to the end of the 10-year holding period may be made tax free to the extent an investor's basis has been stepped-up in an amount sufficient to cover the distribution (whether due to partnership tax allocations of profit and loss, an allocation of leverage incurred by the QOF, upon payment of deferred tax in 2026, or otherwise).

*Multi-Tier Investment; Investment by Members of a Consolidated Group.* Any U.S. taxpayer seeking to obtain the tax benefits offered by the OZ program must invest directly into a QOF rather than through an intermediary such as a fund-of-funds that might act to aggregate investors' capital gains for purpose of investment in QOFs. The Final Regulations have not changed these rules but have loosened the rules relating to consolidated groups. Under the Proposed Regulations, if a consolidated group wished to invest in a QOF, it had to do so through its parent but could not do so through other members of the consolidated group. The Final Regulations have eliminated this restriction. Now, any member of a corporate consolidated group can make the investment.

**Continuing Questions and Uncertainty**

Although the Final Regulations have provided a great deal of useful guidance that is generally favorable to promoting OZ investment, many issues remain uncertain and will require further clarification by the IRS or through the development of practices. The preamble to the Final Regulations specifies certain areas for future guidance. Among the areas where practical issues continue are the manner for integrating partnership tax accounting rules with OZ accounting, FIRPTA withholding tax, the consequences of failing to comply with the 31-month plan for spending capital and other violations of tax requirements (e.g., the 70%, 40% and 50% tests, and more).

**Conclusion**

The issuance of Final Regulations represents another significant step toward providing diverse place-based investment and community development for the benefit of low-income communities throughout the United States and the investors in those communities. With added rules providing flexibility to operating businesses and commingled funds, many in the industry expect a growth in QOFs attracting private capital to a variety of businesses that go well beyond the OZ real estate developments seen in 2018 and 2019.

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