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# FINAL OPPORTUNITY ZONE REGULATIONS

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On December 19, 2019 the IRS published its final regulations on Opportunity Zones. Here are some noteworthy items in the final regulations:

## WHAT TYPES OF GAINS MAY BE INVESTED AND WHEN?

<u>1231 Gains</u>: Section 1231 gains are gains that result from sales of property used in a trade or business, such as gains generated from the sale of rental real estate. Under the proposed regulations, the 180-day period for investing Section 1231 gains began on December 31 of the year in which the sale occurred, and taxpayers were required to net Section 1231 gains against Section 1231 losses.

The final regulations make two substantial changes to rules regarding Section 1231 gains: First, the 180-day period to invest Section 1231 gains runs from the date of that sale - not the end of the year. Second, investors can invest the gross amount of any particular 1231 gain without netting the amount against later Section 1231 losses. *Note, taxpayers may elect to utilize the rule from the proposed regulations.*

<u>Pass-Through Gains</u>: The Service modified the rules regarding situations wherein a pass-through entity has capital gain, but does not itself defer that gain under the OZ rules. Under the final regulations, partners, LLC members, S Corporation shareholders, and beneficiaries of estates and non-grantor trusts now have the option to start the 180-day investment period on: (1) the date that the pass-through entity would have otherwise employed (typically the date of sale); (2) the final day of the pass-through entity's tax year; or (3) the due date for the entity's tax return, without extensions.

<u>Installment Sales</u>: The rules clarify that gains from installment sales are able to be invested when received, even if the initial installment payment was received before 2018.

<u>Nonresident Investment</u>: The final regulations provide that nonresident alien individuals and foreign corporations may make Opportunity Zone investments with capital gains that are effectively connected to a U.S. trade or business.

## WHEN MAY GAINS BE EXCLUDED FROM TAX AFTER AN INVESTMENT IS HELD FOR A TEN-YEAR PERIOD?

<u>Sales of Property by a Qualified Opportunity Zone Business (QOZB)</u>: In the proposed regulations, an investor could only elect to exclude gains from the sale of qualifying investments or property sold by a QOF operating in partnership or corporate form, but not property sold by a subsidiary entity.


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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 ten years. However, the amount of gain will reduce the amount of the investor's interest in the QOF that remains a qualifying investment.

After a ten-year holding period, each of the following is eligible for favorable OZ tax treatment: (1) Sale of an interest in a QOF; (2) Sale of property owned directly by a QOF; (3) Sale of an interest in a qualifying entity held by a QOF; and (4) Sale of property owned by a QOZB.

## INTERACTION WITH SECTION 1031 LIKE-KIND EXCHANGES

Like-Kind Exchanges: The final regulations clarify that an investor can undertake a part like-kind exchange-part QOF investment in appropriate circumstances (though care is required in calculating which portion of the gain may be invested in the OZ investment). Remember, with like-kind exchanges, taxpayers must invest the *net proceeds* of a sale that produced gain; whereas with an OZ investment, taxpayers must only invest the *amount of the gain* from a qualifying sale.

## HOW DOES A FUND DETERMINE LEVELS OF NEW INVESTMENT IN A QUALIFIED OPPORTUNITY ZONE?

Aggregation of property for purposes of the substantial improvement test: For the purposes of determining if a property has been "substantially improved," QOFs and QOZBs can now take into account purchased original use assets that would qualify as Qualified Opportunity Zone Business Property (QOZBP) if the purchased assets: (a) are used in the same trade or business within the Qualified Opportunity Zone (QOZ) or a contiguous QOZ for which a non-original use asset is used, and (b) improve the functionality of the non-original use assets in the same QOZ or a contiguous QOZ. For example, the cost of new fixtures or equipment can be part of the substantial rehabilitation of a used building. Thus, a $10,000 restaurant could pass the test with an $8,000 rehabilitation and the purchase of $2,100 of kitchen equipment and dinner tables that will be used in the restaurant.

In certain cases, the final regulations permit a group of two or more buildings located on the same parcel(s) of land to be treated as a single property. In these cases, any additions to the basis of the buildings in the group are aggregated to determine satisfaction of the substantial improvement requirement. Thus, a taxpayer need not increase the basis of each building by 100% as long as the total additions to basis for the group of buildings equals 100% of the initial basis for the group.

Vacancy period to allow a building to qualify as original use: The final regulations reduce the five-year vacancy requirement in the proposed regulations to a one-year vacancy requirement, if the property was vacant for at least one-year prior to the QOZ being designated and remains vacant through the date of purchase. For other vacant property, the proposed five-year vacancy requirement is reduced to three years. In addition, property involuntarily transferred to local government control is included in the definition of the term vacant, allowing it to be treated as original use property when purchased by a QOF or QOZB from the local government.

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## CHANGES TO THE WORKING CAPITAL SAFE HARBOR

Working Capital Safe Harbor: The final regulations provide several refinements to the working capital safe harbor:

- They create an additional 62-month safe harbor for start-up businesses to ensure that they can comply with the 70-percent tangible property standard, the 50-percent gross income requirement, and other requirements to qualify as a QOZB;
- They provide that a QOZB can receive an extra 24 months to use working capital if the QOZ is in a federally-declared disaster area;
- They clarify that the safe harbor can only be used for a 62-month period and that amounts remaining at the conclusion of the period cannot be counted as tangible property for purposes of the 70-percent tangible property standard;
- They allow a QOZB to treat equipment, buildings, and other tangible property that is being improved with the working capital as QOZBP that is “used in a trade or business” for purposes of the requirement that a QOZB must be engaged in a trade or business; and
- In addition, the final regulations provide that a QOZB not utilizing the working capital safe harbor may treat tangible property undergoing the substantial improvement process as being used in a trade or business.

For more information on how you can take advantage of Opportunity Zone tax incentives, please contact a member of Haynsworth Sinkler Boyd’s economic development or tax practice groups.

Specific information from the U.S. Department of the Treasury “Final Regulations on Opportunity Zones: Frequently Asked Questions,” was referenced and can be found here: https://home.treasury.gov/news/press-releases/sm864.

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