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DECEMBER 24, 2019

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Final regulations for Opportunity Zones . . . Treasury continues to favor real estate

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On December 19, 2019, the IRS issued final regulations ("Final Regulations") on Opportunity Zones ("OZ"). The OZ rules were enacted as part of the 2017 Tax Cuts and Jobs Act ("TCJA"). The Final Regulations continue Treasury's (and the Congress, the President and Administration) favorable treatment of U.S. real estate. The Final Regulations improve and clarify the proposed regulations released in October 2018 and April 2019 (collectively, the "Proposed Regulations").

The Final Regulations span 544 pages and cover a plethora of OZ topics, so what follows is a summary of only certain aspects of the Final Regulations that are either "big topics" or relevant to 2019 year-end planning.[1]

In the near future, please look for a follow-up alert that deals with these and other topics in more detail. This is just a summary — structuring investments and transactions and determining timetables should be done only after consultation with a tax professional. You may certainly feel free to call us with your thoughts and questions.

Year-end rush — some relief!

The Proposed Regulations created a bizarre timing problem with respect to capital gains arising from the sale of certain property used in a trade or business, such as rental real estate, which are "1231 gains." The problem was that, under the Proposed Regulations, these 1231 gains had to be netted against 1231 losses and that calculation was to be done at the end of the year (aptly, for calendar year taxpayers, 12/31). That meant that someone selling a business with both non-1231 and 1231 gains would have a mixed 180-day period within which to invest the proceeds from the sale. For example, say that such a sale took place in April 2019; the non-1231 gain would have to be invested during the period of April 2019 through November 2019 and the 1231 gains would have to be invested during the period of December 31, 2019, through June 2020. These mixed end (and start) dates created a number of potential headaches for various reasons.

[1] For example, there are new rules relating to improving land, investments by consolidated groups, interaction with the tax credit rules, the ability to chain together two 31-month written plans, installment sales, and the tax treatment of cash distributions.

Thankfully, the Final Regulations provide that the gross amount of 1231 gains can be invested under the timing rules applicable to non-1231 gains (without having to wait for the netting of any 1231 losses). This is welcomed relief and, as an added bonus, increases the amount of overall OZ funds in the marketplace, since the gross amount qualifies.

Like a holiday hangover, though, some pain does linger. The Final Regulations do not become effective (for calendar-year taxpayers) until January 1, 2021. While taxpayers like the one in the example above may elect to apply the Final Regulations early, those rules must be applied consistently during all periods before 2021 if this election is made. Therefore, this election would be meaningless if our taxpayer relied on the Proposed Regulations approach in 2018, since she already relied on the extended investment period for her 1231 gains. Taxpayers with 1231 gains from the first half of 2019 are already relying on the proposed regulations. This provides a choice for taxpayers with gains from the second half of the year, recognizing that we are already late into December. Of course, taxpayers who did not know about, or disregarded, the 1231 rules and invested earlier in 2019 are now rescued by the new regulations.[2]

At first glance, there was some concern that if this was the case, then such taxpayers also would have to use the Proposed Regulations for all purposes, but a careful reading reveals that the Proposed Regulations could be applied on a section-by-section basis, so the taxpayer in the above example would simply elect to use the Proposed Regulations for the 1231 rules. Still, this is a bit harsh for those with 1231-gain OZ investments in 2018, since such taxpayers will have to follow the disjointed approach of the Proposed Regulations for 2020 1231 gains, just because they followed the rules in 2018.

The No Tax Exit Rule

The OZ rules provide that if the OZ investment is held for 10 years, then upon exit, there is no tax (on any appreciation that accrues before any exit before 2048) (the “No Tax Exit”). This is the biggest benefit of the OZ rules.

The Final Regulations finally permit all of the following sales to qualify for the No Tax Exit: (a) a qualified opportunity fund (“QOF”) interest held by an investor; (b) a qualified OZ property (“QOZP”) or qualified OZ business (“QOZB”); (c) interests in a partnership, limited liability company (“LLC”), or corporation held by a QOF; and (d) property held by a partnership, LLC, or corporation in which the QOF invests.

Everyone has been clamoring for this, and now it is here. This is a big and very useful change. It will greatly simplify fund formation. Before the Final Regulations, an investor would have had to sell its QOF interest to benefit from the No Tax Exit, but now such an investor can hold onto the QOF interest and the underlying QOZBs and QOZPs can be sold off individually. This facilitates QOFs investment in multiple properties.[3] Further, the new rule appears to allow the sale of any

[2] Another complaint about the Proposed Regulations, as applied to 1231 amounts, is that they forced taxpayers who wanted to invest 1231 proceeds to wait until December 31 (even if they knew that no 1231 losses existed) to deploy the funds. This was a strange result, so it is imaginable that some taxpayers may have deployed the funds in ignorance of the rules or in defiance of the rules.

[3] This puts partnerships on par with REITs that were allowed similar treatment under the Proposed Regulations.

asset held by the QOF or QOZB — even property that constitutes the 10% (at the QOF level) or 30% (at the QOZB level) "bad assets."

Remember, this does ***not*** change the tax rules for sales of property ***during*** the 10-year period. The No Tax Exit rule does not kick in until the 10-year holding period has elapsed. This could create potential issues for QOFs that accept investments over a long period of time, especially if the QOF then buys one project, since those late to the investment will want the property held for the full 10 years, thus delaying the No Tax Exit for investors. This will presumably be dealt with in the QOF's fund documents, but does create a potential conflict of interest and fiduciary duty issues for the manger.

The 100% substantial improvement rule

The substantial improvement rules (which require a QOF or QOZB to spend as much or more than their adjusted basis on improvements to non-original use property) now permit measurement to be done in a way that counts expenditures relating to original use property and applies the test on an aggregate basis. Under the Proposed Regulations, original use property was not counted and the test was applied on an asset-by-asset basis.

A simple example best explains the rules. Assume that a QOF purchases two buildings in contiguous OZs for $500,000 ("Property One") and $600,000 ("Property Two") respectively; does $450,000 of improvements to Property One and $630,000 to Property Two; and buys $25,000 of new furniture for Property Two. Under the Proposed Regulations and a segregated approach, the substantial improvement requirement for Property One is $500,000 and for Property Two it is $600,000. Under the Proposed Regulations, the substantial improvement requirement would have been met for Property Two, but not Property One. Under the Final Regulations, a taxpayer can choose to follow a new aggregation approach, which would require meeting a $1.1 million threshold on a combined basis for Property One and Property Two. In essence, this gives Property One two benefits: First, Property One can use $30,000 of the "excess" improvement cost from Property Two, as long as certain requirements regarding the two properties are met, such as being on contiguous parcels of land and under common management or use. Second, the QOF can count the expenditure of $25,000 for new furniture not only for Property One, but also for Property Two, bringing the total to $1.15 million on an aggregate basis. Moreover, the types of "betterment expenses" go beyond new furniture to cover, importantly, such things as environmental remediation and utility upgrades, which are properly chargeable to the basis of land on which the building sits.

There are various limitations to the aggregative approach. For example, developing side-by-side rental housing buildings can benefit from the aggregate approach, because they are in the same trade or business, while developing a hotel next to rental housing building will not. The regulations also contemplate aggregating improvements to several properties that together constitute a business campus. Finally, properties that are aggregated must either (1) be used and rehabilitated, or (2) be new but improve the functionality of a used property.

The rules also change how long a building has to be vacant to avoid the need for substantial rehabilitation. The requirement was five years in the Proposed Regulations, but the Final Regulations shorten this to one year of vacancy if the property was vacant at the time the census tract was designated an Opportunity Zone, and otherwise, three years.

Application to estate planning transaction

Treasury regulations rarely endorse the use of tax minimization plans, but that's what the Final Regulations appear to do for estate planners. A popular "estate freeze" technique — the use of an intentionally-defective-grantor-trust ("IDGT") — received back-door approval in the preamble to the Final Regulations. In the process of explaining why gifts to grantor trusts are not inclusion events, the preamble makes it clear that an IDGT is still treated as a grantor trust for income tax purposes (even though it is treated as a separate entity for estate and gift tax purposes) and the income tax status drives the determination of what is an inclusion event.

Americans first? International provisions

There was some hope in the tax bar that the Final Regulations would provide an exception to the withholding tax under the Foreign Investment in Real Property Tax Act ("FIRPTA") for an OZ transaction by a foreign investor in U.S. real property. The FIRPTA withholding tax (now 15% of amount realized after TCJA, up from 10%) can be avoided if the foreign seller is able to provide a certificate that states that an exception applies. While the Final Regulations say that the application of the rules is still under consideration, they go on to emphasize that OZ capital gain is not unrecognized gain, but rather deferred gain and thus, as such, would not fit within the non-recognition exceptions to FIRPTA. This suggests that purchasers should be very reluctant to accept any FIRPTA certificate that attempts to claim and OZ exception, although there is a slim chance that future guidance could provide relief (about as likely as FIRPTA repeal).

Further, the Final Regulations make it clear that non-U.S. persons may use the QOZ provisions to defer U.S. capital gains tax that would otherwise have been currently payable on capital gains arising from a U.S. trade or business. However, they also include an anti-abuse provision that explicitly prohibits anyone not otherwise subject to current tax on the capital gain from making an investment in a QOF that would qualify for the No Tax Exit. The anti-abuse provision also requires foreign persons to waive any available treaty benefits that might otherwise have prevented the U.S. from collecting the deferred capital gain tax.

Conclusion

The Final Regulations are lengthy and will require time to consider, but in general, the rules are very taxpayer-friendly and provide yet another reason to give serious consideration to making an OZ investment in a QOF or QOZB. We will provide additional information about the Final Regulations in the coming days, but in the meantime, feel free to reach out to one of us with your questions.

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