Final Regulations Issued Implementing Opportunity Zones Tax Incentive

Alexander J. Szilvas*

This article summarizes a number of important clarifications and changes made to prior guidance by the final Treasury Regulations issued under IRC Section 1400Z-2 implementing the federal Opportunity Zone program. The article discusses provisions of the Final Regulations impacting investors, Qualified Opportunity Funds, Qualified Opportunity Zone Businesses, and Qualified Opportunity Zone Business Property, as well as the effective date and applicability of the Final Regulations.

Introduction

On December 19, 2019, the U.S. Department of the Treasury (the "Treasury") and the Internal Revenue Service (IRS) issued final regulations (the "Final Regulations") under Section 1400Z-2 of the Internal Revenue Code (the "Code")[1] regarding the federal Opportunity Zone program, which was enacted in 2017 as part of the Tax Cuts and Jobs Act.[2] The Opportunity Zone program is intended to encourage investment in certain distressed communities that have been designated as "qualified opportunity zones" (QOZs) by providing tax incentives to invest in "qualified opportunity funds" (QOFs) that, in turn, invest directly or indirectly in the QOZs.

The Treasury and the IRS earlier had issued an initial set of proposed regulations under Section 1400Z-2 in October 2018,[3] and then a second set

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* Alexander J. Szilvas is a partner in the national law firm BakerHostetler LLP where he has practiced tax law for more than 30 years. He may be reached at ASzilvas@bakerlaw.com. The author gratefully acknowledges the assistance and contributions to this article of his colleagues at BakerHostetler LLP, Christina Novotny, Lucas L. Witters, and Cary P. Jones.

[1] All section references throughout this article are to the Code or the Treasury Regulations promulgated thereunder.

[2] P.L. 115-97, 131 Stat. 2054. The Final Regulations were published in the Federal Register on January 13, 2020. See TD 9889, 85 Fed. Reg. 1866 (Jan. 13, 2020).

[3] See REG-115420-18, 83 Fed. Reg. 54279 (Oct. 29, 2018).

of proposed regulations thereunder on May 1, 2019.[4] The Final Regulations revise and consolidate the two sets of proposed regulations (collectively, the "Proposed Regulations"), and they include a number of important clarifications and modifications to the Proposed Regulations. The Final Regulations consist of 544 pages in total (136 pages as published in the Federal Register), including a 355-page preamble (the "Preamble") that provides explanatory material and addresses many comments received in response to the Proposed Regulations, plus the regulations themselves which are 189 pages. The Final Regulations for the most part are quite taxpayer friendly, and they provide comprehensive guidance regarding many aspects of QOZ and QOF investing that should enable taxpayers to proceed with much more certainty in this area.[5]

Background: Overview of Opportunity Funds and Opportunity Zones

By way of background before discussing the Final Regulations, a brief overview of the principal federal income tax benefits and certain key statutory provisions relating to QOZs and QOFs is essential.

Three Primary Federal Income Tax Benefits. Under the Opportunity Zone program, a taxpayer can obtain three principal federal income tax benefits:

1. *Deferral of Capital Gain:* The taxpayer can defer recognition of capital gain if the gain is reinvested within a 180-day period into a QOF.

- The taxpayer generally must recognize the deferred gain on the earlier of (a) the date the investment in the QOF is sold or exchanged or (b) December 31, 2026.

2. *Partial Permanent Gain Exclusion:* If the taxpayer holds its investment in a QOF for at least five years, it may permanently exclude 10 percent of the deferred gain.

- An additional 5 percent of such gain also may be excluded if the taxpayer holds that qualifying investment for at least seven years.[6]

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[4] See REG-120186-18, 84 Fed. Reg. 18652 (May 1, 2019).

[5] Just as this article was going to press, the Treasury and IRS released correcting amendments to the Final Regulations. 85 Fed. Reg. 19082 (April 6, 2020). Some of these corrections affect certain provisions of the Final Regulations that are discussed in this article as noted infra in several places.

[6] The taxpayer must have made its qualifying investment by December 31, 2019, in order to be eligible for this additional 5 percent exclusion benefit.

3. *Permanent Exclusion of Gain From Appreciation in Value of QOF Investment:* If the taxpayer holds its investment in a QOF for at least 10 years, the taxpayer can elect to step up the qualifying basis of such investment to fair market value.

- The effect is permanently excluding from gross income any appreciation in the value of that investment.

Summary of Certain Key Statutory Provisions. Section 1400Z-2 defines a QOF as a corporation or partnership organized for the purpose of investing in qualified opportunity zone property (QOZP) that holds at least 90 percent of its assets in QOZP, measured as of (1) the last day of the first six-month period of the taxable year of the QOF and (2) the last day of the taxable year of the QOF.

QOZP includes qualified opportunity zone stock, qualified opportunity zone partnership interests, and qualified opportunity zone business property (QOZBP):

- QOZBP is tangible property used in a trade or business of a QOF (1) if the property is acquired by purchase after December 31, 2017, (2) the original use of the property begins with the QOF or the QOF substantially improves the property, and (3) substantially all of the use of the property is in a QOZ.
- Qualified opportunity stock or partnership interests include stock or partnership interests acquired after December 31, 2017, for cash, in a corporation or partnership that is a qualified opportunity zone business (QOZB) at the time the QOF acquires the stock or partnership interest (or in the case of a new corporation or partnership, was being organized for purposes of being a QOZB) and throughout substantially all of the QOF's holding period thereafter.
- A QOZB is a trade or business (1) with substantially all of its tangible property, whether leased or owned, being QOZBP (substituting such business for QOF in the definition above); (2) at least 50 percent of the gross income of which is derived from the active conduct of such trade or business; (3) a substantial portion of the intangible property of which is used in such trade or business; (4) less than 5 percent of the assets of which (by aggregate basis) are attributable to non-qualified financial property; and (5) that does not operate a prohibited "sin business."

The Final Regulations

The following discussion highlights a number of important clarifications and changes made by the Final Regulations. The discussion is generally organized first to cover applicability of the Final Regulations, and then to discuss

certain investor, QOF, QOZB, and QOZBP issues, concluding with some additional requirements and matters of general applicability addressed in the Final Regulations.

Applicability of Final Regulations. The Final Regulations went into effect on March 13, 2020, 60 days after they were published in the Federal Register, and are generally applicable to taxable years beginning after that date. This means that for calendar year taxpayers, the Final Regulations are not mandatorily applicable until 2021. For taxable years beginning after December 21, 2017, and on or before March 13, 2020, taxpayers may choose to apply either the Final Regulations or the Proposed Regulations (except for Proposed Regulation Section 1.1400Z2(c)-1), so long as, in each case, they are applied in a consistent manner for all such taxable years.[7]

Investor Issues. There are a number of critical issues for investors, as detailed below.

Treatment of 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. The Proposed Regulations provided that the only gains arising from Section 1231 property that are eligible for deferral under Section 1400Z2 are *net* capital gains determined by netting Section 1231 gains and losses for the taxable year. In addition to limiting the total amount of a taxpayer's eligible gain, this netting rule required taxpayers to wait until the end of the taxable year to start the 180-day period for investing their eligible Section 1231 gains.

The Final Regulations eliminate the netting requirement and provide that eligible gains include *gross* Section 1231 gains (other than those required to be characterized as ordinary income by Sections 1245 or 1250) unreduced by Section 1231 losses. Consequently, under the Final Regulations the 180-day period for investing an eligible Section 1231 gain begins on the date of the sale or exchange that gives rise to the eligible Section 1231 gain and not on the last day of the taxpayer's taxable year.[8] Furthermore, any properly deferred

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[7] Investing in Qualified Opportunity Funds, 85 Fed. Reg. 1866, 1867 (Jan. 13, 2020) [hereinafter Investing in Qualified Opportunity Funds]. This rule also applies with respect to the portion of a taxpayer's first taxable year ending after December 21, 2017. Treas. Reg. § 1.1400Z2(a)-1(g)(2), as corrected. 85 Fed. Reg. 19082, 19083. The corrections to the Final Regulations modify the consistency requirement pertaining to the taxpayer's choice of applying the Final Regulations or the Proposed Regulations in a manner that is somewhat unclear. See, e.g., Treas. Reg. § 1.1400Z2(a)-1(g)(2)(i). Id.

[8] Investing in Qualified Opportunity Funds, supra note 7, at 1869; Treas. Reg. §§ 1.1400Z2(a)-1(b)(11)(iii), 1.400Z2(a)-1(b)(7) (2019).

Section 1231 gains will be netted in the year of inclusion (i.e., December 31, 2026, or earlier year of inclusion) and not in the year of deferral, potentially providing taxpayers with beneficial ordinary loss treatment for their Section 1231 losses in the year of deferral that otherwise would not have existed without the investment of such Section 1231 gains in a QOF.

Installment Sales. The Final Regulations provide clarity on when the 180-day investment timeframe begins for installment sales. To provide flexibility, the Final Regulations permit a taxpayer to choose for its 180-day period to begin on either (1) the date a payment under the installment sale is received, or (2) the last day of the taxable year in which the installment sale gain would be recognized.[9] Thus, a taxpayer could have multiple 180-day periods within a year, or could use the last day of the year for all of the gains that would otherwise be recognized during the year as its 180-day period starting point. The Final Regulations also make clear that gains that would otherwise be recognized after December 22, 2017, even if they pertain to an installment sale that occurred prior to December 22, 2017, would still be able to qualify as eligible gains for purposes of the Opportunity Zone program.

Additional 180-Day Investment Period for Pass-Through Entity Owners. The Proposed Regulations provided that if a pass-through entity (e.g., a partnership or S corporation) incurred an eligible gain, it could elect to invest such eligible gain into a QOF on behalf of all of its owners. If it did not choose to do so, however, each equity owner could elect to invest its distributive share of the pass-through entity's eligible gain into a QOF. In this latter case, each equity owner could choose for its 180-day investment timeframe to begin on either: (1) the last day of the pass-through entity's taxable year, or (2) the day the pass-through entity recognized the eligible gain.

The Final Regulations now provide equity owners in pass-through entities with a third 180-day option. An equity owner also can now choose to begin its 180-day period on the due date of the pass-through entity's tax return (without extensions) for the taxable year in which the pass-through entity realized the gain, recognizing that an equity owner may not know the pass-through entity in which it invested had an eligible gain until receipt of its Schedule K-1 information for the year of the sale.[10]

Sales to QOFs/ QOZBs (Step Transaction Doctrine). The Preamble explains that if a taxpayer sells property to an unrelated QOF and, as part

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[9] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(viii).

[10] Treas. Reg. § 1.1400Z2(a)-1(c)(8)(iii)(B); see also, Investing in Qualified Opportunity Funds, supra note 7, at 1876.

of a pre-arranged plan, thereafter makes a capital contribution of the sales proceeds therefrom to the QOF, (1) such sale would not result in "eligible gain," the proceeds of which could be invested by the taxpayer in exchange for an "eligible interest" in the QOF, and (2) such property would not qualify as QOZBP. Instead, the foregoing transaction would be viewed as a direct contribution of the property from the taxpayer to the QOF in exchange for an equity interest therein under the step transaction doctrine and/or circular cash flow principles.[11] A similar result would occur if the taxpayer sells property to a QOZB and then, also as party of a pre-arranged plan, makes a capital contribution of the sales proceeds therefrom to the QOF, which thereafter transfers those proceeds down to the QOZB. While not directly stated, this result would appear to apply regardless of whether the taxpayer becomes related to the QOF after its QOF investment or not because the Preamble suggests the transaction would be re-cast as a contribution of property, which does not result in eligible gain or QOZBP regardless of the relationship of the contributor to the QOF.[12]

Flexibility on Exit Structures After 10 Years. Section 1400Z-2(c) permits a QOF investor to increase its basis in a QOF interest to fair market value upon a sale or disposition of such interest if the interest is held for 10 or more years, thereby eliminating any appreciation of the QOF interest from the taxpayer's gross income. The Proposed Regulations provided that an investor in a QOF partnership or a QOF S corporation could elect to exclude the capital gain (but not ordinary gain or any gain from the sale of non-qualifying assets) arising from the QOF's sale of qualifying property upon satisfaction of the 10-year holding period. This election provided some flexibility for investors regarding potential exit structures. Importantly, however, the Proposed Regulations did not allow for gain exclusion for lower-tier QOZBs' sales of assets.

The Final Regulations provide significant favorable changes in this area by broadening the scope of the gain exclusion, and also extending gain exclusions to asset sales by lower tier pass-through QOZBs. This expands investors' options with respect to exit structures by now generally providing that investors that have held their QOF partnership or QOF S corporation interest for at least 10 years may elect to exclude *all* gain from sales of assets by (1) the QOF, and (2) lower-tier pass-through QOZBs, other than gains arising

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[11] Investing in Qualified Opportunity Funds, supra note 7, at 1871; see also Treas. Reg. § 1.1400Z2(f)-1(c)(1).

[12] One of the "corrections" made to the Final Regulations expanded Example 3 in Treas. Reg. § 1.1400Z2(f)-1(c)(3)(iii) to add a new (B) providing for a modified fact pattern and an analysis which incorporates the concepts of step transaction and circular cash flow into the actual Final Regulations, which previously had appeared only in the Preamble. See 85 Fed. Reg. 19082, 19086. It also confirms that the result does not turn on whether the taxpayer becomes related as a result of the transaction. Id.

from the sale of inventory in the ordinary course of business.[13] The election is made for each taxable year in which the investor intends to exclude gain.

Inclusion Events. The Proposed Regulations provided for certain specified "inclusion events," which would require an investor in a QOF to recognize all or part of the deferred gains. The Final Regulations modified and clarified certain aspects of these "inclusion events."

Generally, the Final Regulations confirm that an inclusion event will reduce or terminate a qualifying investment in a QOF to the extent of the reduction or termination in such investment. However, the Final Regulations also clarify that qualifying investments in a QOF that have been subject to inclusion events continue to be eligible for tax benefits under Section 1400Z to the extent initially deferred gain has not yet been recognized as a result of the inclusion event.[14] This eliminates concern that the occurrence of an inclusion event by itself automatically would completely terminate a qualifying investment. Also, any gain that would otherwise be recognized as a result of an inclusion event may instead be deferred if invested in another QOF.

The Final Regulations retain the general rules from the Proposed Regulations regarding events that trigger the inclusion of deferred gain. However, they also expressly added as "inclusion events" (1) the loss of a QOF's status as a QOF (either voluntarily or involuntarily), (2) a QOF changing from a partnership to corporation or vice-versa pursuant to the check-the-box regulations, and (3) a transfer of an interest in a QOF to a spouse in connection with divorce proceedings.[15] The Final Regulations also clarify that while death is not an inclusion event, there is no step-up under Section 1014 in the basis of an inherited qualifying investment to fair market value.[16]

Subject to exceptions for wholly owned subsidiaries and members of a single consolidated group and pro rata redemptions of a corporation's only class of stock, the Final Regulations provide that redemptions essentially equivalent to a dividend are inclusion events in their entirety.[17] Reorganizations are also treated as inclusion events to the extent of any boot received as are distributions that are taxable under Section 1059(a)(2).[18] With respect to S corporations, the Final Regulations do not adopt an unpopular concept from

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[13] Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii).

[14] Investing in Qualified Opportunity Funds, supra note 7, at 1881; Treas. Reg. § 1.1400Z2(b)-1(g)(2).

[15] Treas. Reg. §§ 1.1400Z2(b)-1(c)(1)(iv), 1.1400Z2(b)-1(c)(2)(ii), 1.1400Z2(b)-1(c)(3)(ii).

[16] Treas. Reg. § 1.1400Z2(b)-1(g)(6); See also Investing in Qualified Opportunity Funds, supra note 7, at 1890.

[17] Treas. Reg. § 1.1400Z(b)-1(c)(9).

[18] Treas. Reg. §§ 1.1400Z2(b)-1(c)(8), 1.1400Z2(b)-1(c)(10)-(12).

prior guidance that would have treated a transfer of more than 25 percent of the ownership in an S corporation as a disposition of such corporation's investment in a QOF. With respect to partnerships, the Final Regulations clarify that, while distributions from a QOF partnership in excess of a partner's basis in its partnership interest are inclusion events, distributions from a partnership that owns an interest in a QOF to its partners in excess of their outside bases would be inclusion events only if such distributions are liquidating distributions.[19]

Treatment of Consolidated Groups. Prior guidance limited the ability of consolidated groups to take advantage of investments in QOFs, prohibiting a QOF from being included as a subsidiary member of a consolidated group and requiring that the same member of a consolidated group recognize a capital gain, invest that gain in a QOF, and report the resulting tax benefits.

Under the Final Regulations,[20] a QOF may be included as a subsidiary member of a consolidated group if, subject to limited exceptions, the group member that makes the qualifying investment in the QOF member maintains a direct equity interest in the QOF and all QOF investors must be wholly owned, directly or indirectly, by the common parent of the consolidated group.[21] Given this change, the Final Regulations also provide special rules that (1) require members of a consolidated group to address excess loss accounts under Treasury Regulation Section 1.1502-19 before adjusting basis in QOF stock under Section 1400Z-2(c); (2) treat distributions from a QOF subsidiary member to its investor member as inclusion events to the extent they would create or increase an excess loss account with respect to such stock; (3) apply rules similar to those applicable to partnerships for calculating the amount of gain to be included as a result of an inclusion event; (4) treat sales or exchanges of property between members of the QOF's separate affiliated group and other members of the consolidated group not as intercompany transactions subject to the rules of Treasury Regulation Section 1.1502-13; and (5) prohibit treating a consolidated group as a single entity for purposes of determining whether a QOF member or QOZB satisfies the investment requirements under Sections 1400Z-2(d) and (f) and the

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[19] Treas. Reg. § 1.1400Z2(b)-1(c)(6)(iii).

[20] The portions of the Final Regulations regarding the application of the Opportunity Zone rules to members of consolidated groups are promulgated under not only IRC § 1400Z-2(e)(4) but also IRC §§ 1502 and 1504(a)(5). The location of those Final Regulations was moved as a procedural matter from Prop. Treas. Reg. § 1.1400Z2(g)-1 to Treas. Reg. §§ 1.1502-14Z and 1.1504-3. See Investing in Qualified Opportunity Funds, supra note 7, at 1934–40.

[21] Treas. Reg. § 1.1504-3(b)(2).

regulations promulgated thereunder.[22] Recognizing the complexity of interplay between the Opportunity Zone requirements and consolidated group rules, the Final Regulations also include a general anti-abuse rule.[23]

The Final Regulations also permit an election to treat the investment by one member of a consolidated group as if made by another member of the group. The election is permitted where one member of the group has eligible gain and another member of the group makes an investment in a QOF that would be a qualifying investment if the group member with the eligible gain were the investor. If the group makes such an election, the members of the group treat the QOF investment as if made by the member with the eligible gain and then immediately sold to the other member for fair market value.[24]

QOF Issues. The regulations also address several issues related to QOFs specifically.

Recently Contributed Property. The second tranche of Proposed Regulations permitted a QOF to disregard any property it receives within the six-month period preceding an applicable testing date for purposes of the 90 percent asset test under Section 1400Z-2(d)(1) as long as such contributions are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. The Final Regulations retain this important grace period and also grant a QOF five business days to convert contributed property into cash, cash equivalents, or short-term debt instruments in order to qualify.[25] However, the Final Regulations did not adopt the request of commenters that such recently contributed property should be treated as invested in QOZP as long as it is so invested by the next testing date that is more than six months after the property is received. This could in some start-up cases pose challenges with the 90 percent test.

Six Month Cure Period. The Final Regulations adopted the provisions in the Proposed Regulations clarifying that a QOZB must qualify as a QOZB for "substantially all" of a QOF's holding period for QOZB stock or partnership interests, meaning 90 percent of such period.[26] The Final Regulations also

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[22] Treas. Reg. § 1.1502-14Z(b)(1)(iii) (excess loss accounts and basis); Treas. Reg. § 1.1502-14Z(b)(1)(i) (distribution as an inclusion event); Treas. Reg, § 1.1502-14Z(b)(ii) (determining amount of deferred gain includible); Treas. Reg. § 1.1502-14Z(b)1)(iv) (sales or exchanges between members of QOF's separate affiliated group and other members of the consolidated group); Treas. Reg. § 1.1502-14Z(b)(1)(v) (single entity prohibition).

[23] Treas. Reg. § 1.1502-14Z(b)(2).

[24] Treas. Reg. § 1.1502-14Z(c)(2).

[25] Treas. Reg. § 1.1400Z2(d)-1(b)(2)(i)(B).

[26] Treas. Reg. §§ 1.1400Z2(d)-1(c)(2)(C), 1.1400Z2(d)-1(c)(3)(C).

provide that if a trade or business causes a QOF to fail this 90 percent standard on one of its semi-annual testing dates, the QOF can treat its stock or partnership interest in the trade or business as QOZP if the trade or business corrects the failure and qualifies as a QOZB within six months of the date on which it began to fail to so qualify. The six-month cure period may only be applied once to a QOZB.[27]

QOZB Issues. The regulations also clarify some issues related to QOZBs.

Gross Income Test. The Proposed Regulations provided safe harbors for calculating whether 50 percent of the gross income from a trade or business is derived from the active conduct of such trade or business in a QOZ, as required under Section 1400Z-2(d)(3)(A)(ii) (by reference to Section 1397C(b)(2)). The Final Regulations adopt and clarify the safe harbors, and also include rules permitting a QOZB to aggregate income from different QOZs in order to meet the safe harbor.

In particular, the May 2019 Proposed Regulations provided that, if at least 50 percent of the services performed for the trade or business are performed in a QOZ, based on (1) total number of hours performed by employees and independent contractors and employees of independent contractors in a QOZ (hours performed test), or (2) amounts paid to employees and independent contractors and employees of independent contractors in a QOZ (amounts paid test), then the trade or business is deemed to satisfy the 50 percent gross income requirement.

For purposes of calculating the hours worked or amounts paid for services performed under the safe harbor, the Final Regulations specify that hours worked by partners in a partnership and guaranteed payments made to partners in a partnership count for purposes of these calculations, in addition to hours worked by and payments made to employees, independent contractors, and employees of independent contractors as in the Proposed Regulations.[28]

Working Capital Safe Harbor. The Proposed Regulations granted QOZBs that acquire, construct, and/or substantially improve tangible business property a 31-month "working capital safe harbor." This permits such QOZBs to treat certain cash equivalents and short-term debt instruments as reasonable amounts of working capital to be excluded from the definition of non-qualified financial property if certain requirements are satisfied. In response to comments that a start-up business may require a longer lead time than 31 months, the Final Regulations grant an additional 31-month safe

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[27] Treas. Reg. § 1.1400Z(d)-1(d)(6).

[28] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(i)(A)-(B).

harbor period, for a maximum of up to 62 months, in certain cases. These involve multiple cash infusions of more than de minimis amounts during each 31-month period which were an integral part of the original working capital safe harbor plan.[29] The Final Regulations also clarify that not only will working capital be excluded from the definition of non-qualified financial property throughout the safe harbor period, but also (1) any gross income earned from the working capital can be used to satisfy the 50 percent gross income requirement, (2) tangible property purchased with such working capital can qualify as QOZBP, and (3) intangible property purchased or licensed with such working capital can count toward the 40 percent intangible property use requirement.[30]

Active Conduct of a Trade or Business. The Proposed Regulations provided that merely entering into a triple net lease would not constitute the "active conduct" of a trade or business by a QOF or QOZB. The Final Regulations provide some clarity, but still leave open questions on this topic. By example, the Final Regulations confirm that entering into one triple net lease encompassing all of a property does not constitute active conduct of a trade or business.[31] Beyond that, the Final Regulations do not draw bright lines but provide by example that entering into a triple net lease and other leases that are not triple net for portions of the same property may constitute active conduct of a trade or business.[32] That example is helpful in providing some flexibility and confirming that a rental real estate business can carry on some portion of its activities through triple net leasing and still be treated as conducting an active trade or business. The example also indicates that some meaningful landlord participation in the management and operations of the real estate is important.

Prohibited "Sin Businesses." Section 1400Z-2(d)(3)(A)(iii) excludes the businesses described in Section 144(c)(6)(B) from qualification as a QOZB. These "sin businesses" include any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or store the principal business of which is the sale of alcoholic beverages for consumption off premises. Interestingly, the statute excludes these sin businesses from the definition of QOZB but does not prohibit QOFs from engaging in sin businesses directly. The statute also does not clearly prohibit a QOZB from leasing property to a tenant engaged in one of the sin businesses. The Final Regulations, like

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[29] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(F).

[30] Treas. Reg. § 1.1400Z(d)-1(d)(3)(vi)-(vii).

[31] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iii)(C)(1).

[32] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iii)(C)(2).

the statute, do not prohibit a QOF from directly operating a sin business. The Final Regulations do, however: (1) prohibit a QOZB from leasing more than 5 percent of its property to tenants engaged in sin businesses and (2) permit a QOZB to derive less than 5 percent of its gross income from sin businesses without jeopardizing its qualification as a QOZB.[33] With this 5 percent income "de minimis" safe harbor, the IRS declined invitations from commenters to provide any more definitional clarity on what constitutes conducting one of the enumerated sin businesses.

Intangible Property. The Final Regulations also clarify that a QOZB will meet the requirement that a substantial portion (previously established at 40 percent) of its intangible property is used in the active conduct of a trade or business in a QOZ if its use of the intangible property is normal, usual, or customary in the conduct of its trade or business and the intangible property is used in a QOZ to perform an activity that generates income for the trade or business.[34]

QOZBP Issues. The regulations elaborate on QOZBP issues.

"Original Use" Issues. For property to qualify as QOZBP the original use of the property within the QOZ must begin with the QOF or QOZB, or the QOF or QOZB must substantially improve the property. The second tranche of Proposed Regulations would have permitted buildings that were vacant for five continuous years to meet this "original use" test when placed into service in the QOZ.

Vacant Properties. The Final Regulations provide more flexibility and clarification for vacant properties. First, the Final Regulations specify that real property, including land and buildings, is considered vacant if more than 80 percent of the building or land, as measured by usable square footage, is not being used.[35] The Final Regulations also eliminate the five-year period contemplated in the second tranche of Proposed Regulations and instead permit buildings that have (1) been vacant for at least one year prior to designation of the QOZ and remained vacant through the date of the property's purchase by a QOF or QOZB, or (2) remained vacant for three continuous years, to meet the "original use" test when the QOF or QOZB places the property in service in the QOZ.[36]

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[33] Treas. Reg. § 1.1400Z2(d)-1(d)(4)(iii).

[34] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(ii)(B).

[35] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(iii).

[36] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(i)(B).

Brownfields and Certain Local Government Property. The Final Regulations also create new avenues for previously used property to satisfy the "original use" requirement. Property that meets the brownfield site definition under 42 U.S.C. Section 9601 will meet the "original use" requirement if the QOF (or QOZB, as applicable) makes investments in the site within a reasonable period to ensure that all property composing the site meets basic safety standards for both human health and the environment.[37] Also, any real property that an eligible entity purchases from a local government that acquired the property via involuntary transfer (e.g., abandonment, bankruptcy, foreclosure, or receivership) will meet the "original use" requirement.[38]

Substantial Improvement. If a taxpayer seeks to rely on the substantial improvement concept in order to satisfy the "original use" requirement, the Final Regulations provide some helpful guidance in this area as well. The Proposed Regulations had provided for a 30-month period over which taxpayers could make improvements exceeding the adjusted basis of a building as of the beginning of such period to meet the "substantial improvement" test. The Final Regulations permit taxpayers to include the cost of property located in the same or a contiguous QOZ that is used in the same trade or business as, and improves the functionality of, the non-original use property in calculating the costs of improvements for purposes of the "substantial improvement" test.[39] The Final Regulations also permit taxpayers to treat improvements to property as QOZBP throughout the 30-month rehabilitation period provided that the taxpayer reasonably expects to pass the substantial improvement test by the end of the 30-month period.[40]

Improvements Made to Non-Qualified Opportunity Zone Property. The Preamble provides that improvements made to non-qualified Opportunity Zone property (because it was purchased on or before December 31, 2017, purchased from a related party, lacks substantial improvements, or was acquired by way of a contribution or otherwise than by purchase), do not satisfy original use requirements.[41] This is in contrast to lessee improvements which are expressly treated as separate property.

Land as QOZBP. The Proposed Regulations indicated that if a QOF (or QOZB, as applicable) acquires land in a QOZ by purchase after

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[37] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(iv).

[38] Treas. Reg. § 1.1400Z2(d)-2(b)(3)(v).

[39] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iii).

[40] Treas. Reg. § 1.1400Z2(d)-2(b)(4)(ii).

[41] Investing in Qualified Opportunity Funds, supra note 7, at 1909.

December 31, 2017, such land (1) need not satisfy the original use requirement whether it is improved or unimproved, and (2) need not be substantially improved. These exceptions were not available, however, if the land is unimproved or minimally improved and the eligible entity had no intention or expectation to improve the land by more than an insubstantial amount within 30 months of the purchase.

The Preamble confirms in response to comments that land need not meet the original use or substantial improvement tests to qualify as QOZBP so long as it will be improved by more than an insubstantial amount. The land, however, must meet all other applicable requirements under Section 1400Z-2(d)(2)(D) and the applicable regulations.[42] The Final Regulations do not define "insubstantial amount," instead focusing on facts and circumstances and providing guidance through examples. However, the Final Regulations do provide that activities such as grading or clearing land and remediation of contaminated land will be taken into account.

General Matters. There are a few more general matters warranting consideration.

Valuation Methods. Consistent with the Proposed Regulations, the Final Regulations generally permit QOFs and QOZBs to utilize one of two methods to value their assets for purposes of the "90 percent test" and the "70 percent test," respectively:

1. *The Applicable Financial Statement Method:* If a QOF or QOZB has an "applicable financial statement" (within the meaning of Treasury Regulation Section 1.475(a)-4(h)), as long as such financial statement is prepared according to U.S. generally accepted accounting principles (GAAP), such entity may use the values from its applicable financial statement to value its assets for purposes of its Opportunity Zone asset test.[43]

2. *The Alternative Valuation Method:* This alternate valuation method prescribes different valuation rules for owned and leased property. For owned property, the Final Regulations provide for the QOF or QOZB, as applicable, to value property that was either purchased or constructed for fair market value (FMV) using the entity's unadjusted cost basis under Section 1012 or 1013 of the Code. For

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[42] Investing in Qualified Opportunity Funds, supra note 7, at 1915.

[43] Treas. Reg. §§ 1.1400Z2(d)-1(b)(2)(i)(A), 1.1400Z2(d)-1(b)(2)(ii)(A), 1.1400Z2(d)-1(b)(3).

> all other owned property, such entity must use the property's FMV. For leased property, the value for purposes of the 90 percent test or 70 percent test, as applicable, is the present value of the lease payments for the property determined in accordance with the Final Regulations.[44]

While these valuation methods are generally consistent with the Proposed Regulations, the different ways to value owned property under the alternative valuation method is a change. The new requirement to value non-purchased/non-constructed property using FMV suggests that partnership interests (e.g., qualified opportunity zone partnership interests owned by a QOF) must now be re-valued on each applicable testing date, likely complicating the annual valuation process for QOFs that choose to utilize the "indirect" Opportunity Zone investment model.[45] This new rule also could require carried interests (i.e., a non-qualifying asset for both the 90 percent test and 70 percent test) to be valued higher, potentially making it more difficult for a QOF or QOZB to meet its respective asset test.

General Anti-abuse Rule. The Proposed Regulations contained a general anti-abuse rule aimed at ensuring that taxpayers' transactions remain consistent with the purposes of Section 1400Z-2. Under such rule, if, based on all the facts and circumstances, a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of Section 1400Z-2, the transaction (or series of transactions) will be recast or recharacterized for federal income tax purposes as appropriate to achieve results that are consistent with the purposes of Section 1400Z-2.

The Final Regulations maintain the Proposed Regulations' anti-abuse rule and, in response to requests by commenters, provide a specific statement of the purposes of Section 1400Z-2 and the Final Regulations, which are (1) to encourage longer-term investments, through QOFs and QOZBs, of new capital in QOZs, and (2) to increase the economic growth of such QOZs. The Final Regulations then provide seven examples that illustrate the application of the anti-abuse rule in a variety of contexts.[46]

With respect to the rule's application to land transactions, one of the examples posits land acquired by a QOZB with no plan or intent to develop or otherwise utilize the land in a trade or business that would increase substantially the economic productivity of the land. Instead, there was a plan

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[44] Treas. Reg. § 1.1400Z2(d)-1(b)(4).

[45] This potential issue appears to have been addressed in corrected Treas. Reg. § 1.1400Z2(d)-1(b)(4)(ii)(A) (2020). See 85 Fed. Reg. at 19083.

[46] Treas. Reg. § 1.1400Z2(f)-1(c).

to pave the land for use as a parking lot, install a gate and small structure to serve as an office for a parking attendant, and create two self-pay stations. There was no reasonable expectation that the parking lot or number of employees would expand significantly, and a significant purpose for the land acquisition was to sell the land at a profit and exclude any appreciation from gain. Under these facts, the example concludes that the land acquisition is a transaction carried out to achieve a result that is inconsistent with the purposes of Section 1400Z-2 and the Section 1400Z-2 regulations. Therefore, the land will not qualify as QOZBP and the gain from sale of the land will not be eligible to be excluded from gross income under Section 1400Z-2(c).[47]

An additional example involves farmland acquired by a QOZB with an intent to convert a pig and hog farming operation into a goat and sheep farming operation. The example states that goat and sheep farming activities were conducted on the land during the 10-year period beginning on the date of acquisition, and the QOZB made significant capital improvements to the land, including improvements to existing farm structures, construction of new farm structures, and installation of a new irrigation system. Under these facts, this is not a transaction that will be recharacterized under the anti-abuse rule, even though there was an expectation from the time of acquisition of the land that its value would increase substantially over the anticipated holding period of the QOZB.[48]

Conclusion

The Final Regulations represent a very commendable effort by the Treasury and IRS to try to provide comprehensive and workable rules to implement the Opportunity Zone program. Several hundred formal comment letters and additional taxpayer input were taken into account in promulgating the Final Regulations, and the Final Regulations incorporate many (but certainly not all) suggested provisions and requests from commenters and taxpayers. The Final Regulations are mostly taxpayer favorable, although there are some instances in which the Proposed Regulations may allow for a more taxpayer friendly result.

The Final Regulations went into effect on March 13, 2020. However, taxpayers generally can choose to apply either the Proposed Regulations or the Final Regulations (as long as they are applied on a consistent basis) for all tax years beginning on or before March 13, 2020. Thus, for example, this option is available to individuals and other calendar year taxpayers for the current 2020 tax year. Taxpayers may wish to review and consider the treatment of their particular Opportunity Zone situations for the current and prior tax years with their tax advisors under both the Final

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[47] Treas. Reg. § 1.1400Z2(f)-1(c)(3)(iv).

[48] Treas. Reg. § 1.1400Z2(f)-1(c)(3)(v).

Regulations and the Proposed Regulations. In the near term, this would appear to provide an opportunity to assess which set of these regulations (or perhaps some combination under the newly corrected Final Regulations) could provide a better result in a given case for current transaction planning and also for prior tax periods.

It is widely anticipated that the issuance of the Final Regulations will provide sufficient clarity and certainty in the application of the Opportunity Zone rules to stimulate additional taxpayer investment in QOFs and participation in the Opportunity Zone program as taxpayers seek to obtain the considerable tax benefits afforded by the program. This should help further the ultimate intended purpose of the Opportunity Zone program, namely to encourage investment in certain distressed communities that have been designated and certified as QOZs by providing tax incentives.

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