KPMG

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KPMG report: Initial impressions of final regulations for opportunity zones

The U.S Treasury Department and the IRS yesterday released final regulations (T.D. 9889) under section 1400Z-2, regarding rules for investments in opportunity zones. These regulations finalize rules that were promulgated in two tranches of proposed regulations in October 2018 and May 2019.

Read the text of the **final regulations** [PDF 1.33 MB] (544 pages)

Overview

Section 1400Z-2 relates to capital gains that may be deferred as a result of a taxpayer's investment in a qualified opportunity fund (QOF) that holds property and operates in a qualified opportunity zone (QOZ). The provision was added to the Code by the 2017 tax reform legislation (Pub. L. No. 115-97 enacted December 22, 2017—and often referred to as the "Tax Cuts and Jobs Act"). Even after two rounds of regulatory guidance from the government, there were fundamental questions about aspects of the program.

The eagerly anticipated final regulations provide clarity around a host of issues that were of critical importance to both potential investors in the program and businesses interested in taking advantage of the incentives provided for operating in QOZs. The final regulations also provide several new rules and expansions of previously provided safe harbors that appear to be favorable in terms of investment, development, and operation of projects in QOZs.

The following are some highlights of the significant provisions in the final regulations. An in-depth discussion of the rules and KPMG's observations will be published in the near future.

From the QOZ investor's perspective

Eligible gains

- The final regulations expand the ability of taxpayers to **roll over gains from QOF inclusion events.** The proposed regulations provided that such gains could only be reinvested as qualifying investments if the taxpayers disposed of 100% of their initial QOF interest. The final regulations provide that any gain arising from an inclusion event is eligible for deferral if invested in a QOF within 180 days.

Timing of gains

- The final regulations depart from the proposed regulations treatment of section 1231 gains and generally **adopt a gross gain approach to eligible section 1231 gains** (that is, it does not require netting against section 1231 losses). As a consequence of this gross gain treatment, the 180-day period for investing eligible section 1231 gains generally begins on the date of the sale or exchange that gave rise to the gain.

- The final regulations provide additional time to invest for taxpayers who receive capital gains from partnerships, S corporations, and non-grantor trusts. At a taxpayer's option, the taxpayer **can elect to begin its 180-day investment period on the due date of the entity's tax return** (not including extensions). This rule was a recognition by Treasury and the IRS that many holders of interests in passthrough entities may not receive notice of their eligible gains until the entities have issued Schedule K-1s.

- The final regulations clarify the timing of the 180-day investment period with respect to **installment sale gains.** The rules provide two options that the taxpayer may elect: (1) start the 180-day clock on the date a payment is received, or (2) start the clock on the last day of the tax year in which the eligible installment sale gain would be recognized. This means 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 included in income during the year.

Eligible taxpayers

- The final regulations clarify that deferral via QOF investment is only available for gains that would be subject to federal income tax. This means for non-U.S. investors that **gain that is effectively connected with a U.S. trade or business generally is eligible** (although there is an exception to this rule if the gain is exempt under a treaty and does not waive the rights under the treaty).

From the QOZ business and project perspective

Working capital safe harbor

- The final regulations provide that tangible assets can benefit from up to two 31-month safe harbors for **a total of 62-months**. These rules are not a straightforward grant of 62 months to complete a project or begin a business, but rather require additional amounts of working capital and working capital plans that take into account the additional amounts.

- The final regulations do provide **clarity with respect to the treatment of in-progress assets and gross income generated by working capital safe harbor assets** during the safe harbor period, and confirm that such assets and income will be treated as used in a trade or business and generated from a trade or business during the safe harbor.

Substantial improvement

- The final regulations provide a number of **aggregation rules** that replace the asset-by-asset approach for purposes of determining whether a property or group of properties has been sufficiently improved. Generally, property can count toward the substantial improvement requirement if it is in the same QOZ, used in the same trade or business, and improves the functionality of the non-original use property.

- In addition to the general aggregation rule, the final regulations provide a specific **aggregation approach for groups of buildings**. The rules vary depending on the profile of multi-building projects, but generally require operation by the same entity, shared business elements, and coordinated operations. If these requirements are satisfied, the aggregate basis of the buildings sets the baseline for improvement and the collective improvements are counted against that amount.

Original use and vacancy

- The **period of time property has to be vacant** in order to be considered original use was reduced by the final regulations. Property that's been vacant for one year before the designation of the QOZ in which it sits is eligible. Property that becomes vacant in a designated QOZ must be vacant for three years in order to become original use.

- The final regulations generally **define vacant as less than 80%** of useable space being in use.

Leasing issues

- The final regulations provide a number of **examples that illustrate triple-net lease scenarios** and discuss factors that may be used to determine qualification as a trade or business in the leasing context.

Use of property

- The final regulations attempt to provide a clearer definition of what **it means to "use" tangible and intangible property** in a QOZ. There are a number of factors and safe harbors applicable to property that is used both in and outside QOZs.

- The final regulations provide qualified opportunity zone businesses (QOZBs) with one **six-month period to cure a QOZB's compliance failure** and thereby avoid causing a QOF owner to fail its 90% asset test.

Structuring QOFs and QOZBs

Post 10-year dispositions

- The proposed regulations provided that a passthrough QOF that was beyond the 10-year holding period could sell property, including interests in a QOZB, and exclude the capital gains on such sales. The final regulations **extend this rule to sales of property by QOZBs**. Furthermore, the final rules allow the **exclusion of all gains** (not just capital gains), aside from gains on the sale of inventory in the ordinary course of business.

- The final regulations also clarity that a partner's stepped-up basis in a QOF partnership following a 10-year election is **equal to the net FMV of the interest plus the partner's share of the partnership debt** related to the interest.

Consolidated rules

- The final regulations make significant changes to the proposed rules with respect to consolidated groups. **C corporation QOFs may be members of a consolidated group** under the final regulations. Also, investment in a QOF is **not limited to the consolidated group member that realized the capital gain**—investments can be made by other consolidated group members on behalf of the member that realized a capital gain.

Valuations

- The alternative valuation method, whereby a QOF can use the original cost basis of assets for purposes of determining its 90% asset testing compliance, is **only available to value assets owned by a QOF that are acquired by purchase or constructed for FMV**. This means that the alternative valuation method cannot be used to value partnership interests or other intangible assets held by the QOF (that is, the final regulations require determination of FMV for these assets at each testing date).

Timing and reliance on the final regulations

Note that the applicability date of each section of these final regulations is generally tax years beginning after 60 days from the official publication of the regulations in the Federal Register. This means that taxpayers who are, or were, relying on provisions of a section of the proposed regulations for purposes of their 2019 year-end tax planning (e.g., in terms of timing on section 1231 gain amounts) can continue to rely on those rules, assuming they are applied consistently.

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