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Federal Tax Bulletin: Final Qualified Opportunity Zone Regulations Adopt Many Changes

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On December 19, 2019, two years after the federal Qualified Opportunity Zone (**QOZ**) program was enacted, the Treasury Department released final regulations providing guidance on how to apply the rules under this program. These final regulations largely conform to the proposed regulations that Treasury had previously issued. However, there are many important changes incorporated into the final regulations, generally reflecting an effort by Treasury to make the rules work better for taxpayers.

Background

Under the QOZ program, taxpayers who have recognized qualifying capital gain within the prior 180-day period may obtain federal tax benefits by investing all or part of the amount of such capital gain in a Qualified Opportunity Fund (a **QOF**), and by holding the resulting QOF equity interest for an extended period of time. A QOF is required to satisfy a number of rules designed to ensure that the QOF deploys new assets into QOZs and that such assets remain within QOZs.

The federal income tax benefits available to a taxpayer generally include:

- Deferral of taxation of the qualified capital gain until the earlier of the date the QOF equity interest is transferred, or December 31, 2026. In addition, (i) 10% of the federal tax on that gain is eliminated if the QOF equity interest has been held for at least 5 years prior to the gain recognition date, and (ii) an additional 5% of the federal tax on the gain is eliminated (for a total of 15%) if the QOF equity interest has been held for at least 7 years prior to such date.
- Complete elimination of taxation of gain on the taxpayer's disposition of the QOF equity interest, if the QOF equity interest has been held for at least 10 years prior to the disposition.

Vorys has addressed certain aspects of these general rules in prior bulletins (New Federal Qualified Opportunity Zone Program; Qualified Opportunity Zones: Proposed Regulations Provide Investors with

Guidance on Several Important Questions; and Key Timing Issues for Qualified Opportunity Fund Investments).

Final Regulations

Although a comprehensive list of the changes incorporated into the final regulations is beyond the scope of this bulletin, the following outlines a number of these changes:

180-Day Investment Window

Gain from Sale of Business Property. Under the proposed regulations, taxpayers could only roll over into a QOF the *net* gain resulting from the sale of business property for any taxable year. Therefore, taxpayers had to wait until the end of a taxable year to determine whether they had net gain from the sale of business property. In addition, the 180-day window for investment into a QOF with respect to such gain did not commence until the last day of the taxpayer's taxable year. (Vorys addressed these rules in a previous bulletin.) Treasury eliminated this rule in the final regulations. Now, (i) capital gain recognized from the sale of a business asset may be rolled into a QOF irrespective of any capital losses the taxpayer may recognize from the sale of business assets during the same year, and (ii) the 180-day window for investment begins on the date of the asset sale.

Partnership Gain. Where a partnership recognizes capital gain and does not make a corresponding QOF investment, a partner may itself make a qualifying QOF investment with respect to their share of the capital gain. In such event, special rules relating to the 180-day investment window apply. Under the proposed regulations, a partner had the option of selecting a 180-day window that begins on either the date of the partnership's sale of the capital asset, or on the last day of the partnership's taxable year. The final regulations retain these options and provide partners with a third option as well: the 180-day period beginning on the original due date of the partnership's federal income tax return for the taxable year of the gain. (The same rules apply to S corporations and their shareholders, and estates and nongrantor trusts and their beneficiaries.)

Substantial Improvement of Property. If a QOF acquires a property that previously has been used in a QOZ, the QOF generally is required to substantially improve the property. The final regulations incorporate the following changes to Treasury's prior guidance:

- ***Brownfield remediation.*** Brownfield sites are treated as not previously used in a QOZ if a QOF makes investments in the site to ensure that it meets basic safety standards for both human health and the environment.

- ***Vacancy:*** Real property that is vacant (i.e. more than 80% unused) will be treated as not previously used in a QOZ if, prior to its acquisition by a QOF, the property was vacant for at least 3 years (or, if the property was vacant at the time that the QOZ was first designated as a QOZ, at least 1 year).

- ***Personal Property/Aggregation.*** In determining whether a taxpayer's improvements to an asset are "substantial," taxpayers are permitted to include the acquisition costs of certain other assets that improve the functionality of the improved asset in the intended business (for example, the acquisition of furniture for use in a hotel). In addition, under certain circumstances, multiple buildings may be treated as a single building in determining whether improvements have been substantial.

Sale of Property by Certain QOFs or QOF Subsidiaries. As mentioned above, after 10 years a taxpayer can achieve full QOZ benefits through a sale of their QOF equity interest. Under the final regulations, for taxpayers holding equity interests in a QOF treated as either a tax partnership or S corporation, full QOZ benefits can also be achieved through a sale of assets by the QOF, or by a QOF subsidiary treated as a tax partnership. (Under the proposed regulations, receipt of full tax benefits required the sale of the taxpayer's QOF equity interest.)

31-month Deferral of Working Capital Limitation. The QOZ rules generally place tight limitations on the ability of a QOF, and QOF subsidiaries, to hold cash. For QOF subsidiaries, the proposed regulations include a special rule deferring the application of this limitation for 31 months after cash is contributed to the QOF, so long as certain requirements are met. The final regulations provide for the following additional periods:

- ***Tolling in the Event of Government Delay.*** In the event that utilization of cash by a QOF subsidiary is delayed as a result of waiting for government action (e.g., a permit) the application for which is complete, the 31-month period is tolled.
- ***Two 31-month periods.*** Additional capital may be contributed, and an additional 31-month period used (for a total of 62 months), with respect to a single asset if the subsequent cash contribution forms an integral part of the plan covered by the initial 31-month period.

Effective Date

The final regulations are effective for tax years beginning after March 13, 2020. For tax years beginning on or before that date, Treasury has indicated that taxpayers can choose either to apply the final regulations or the proposed regulations, in each case only if applied in their entirety and in a consistent manner for such tax year. Although this interpretation of the effective date provisions is not entirely clear from the language of the final regulations, based upon Treasury's interpretation, taxpayers who relied on any unique aspect of the proposed regulations for any tax year beginning on or before March 13, 2020 would need to apply the proposed regulations in their entirety for such years.

Contact your Vorys attorney to find out more about these, or other aspects of the final Qualified Opportunity Zone regulations.