



# Guide to Opportunity Zones and the Final Regulations

WIPFLI

## Wipfli Opportunity Zone Team Leaders



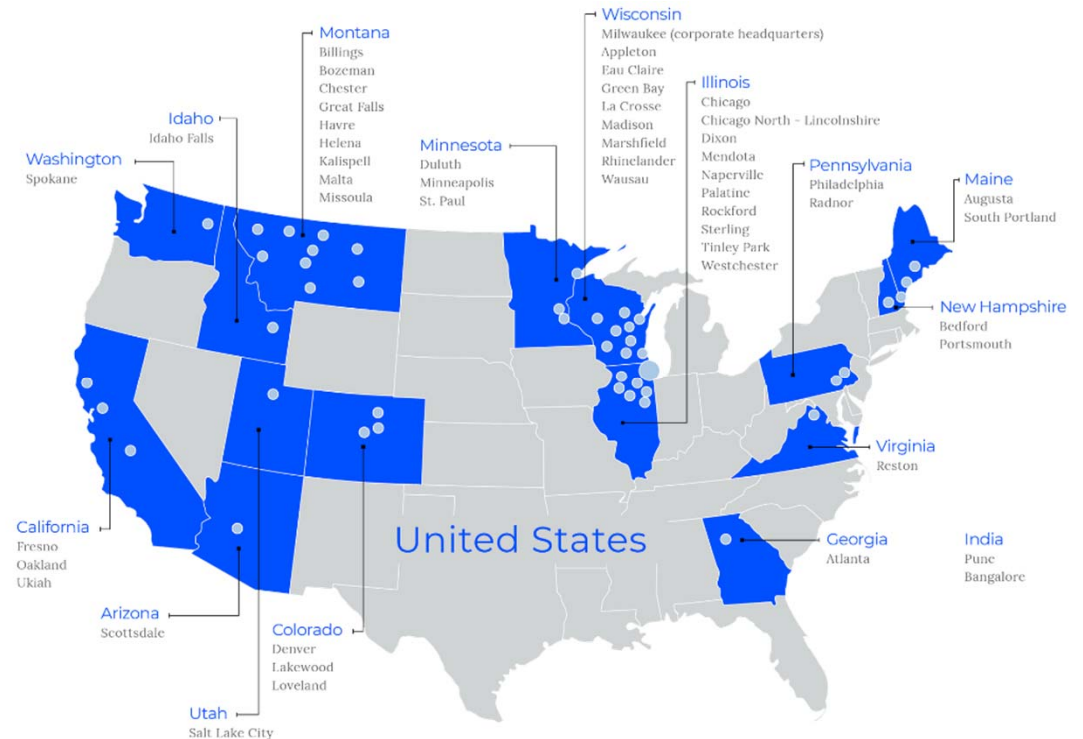
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# Wipfli LLP

- Firm founded in 1930
- Headquartered in Milwaukee
- 250+ partners
- 2,400+ associates
- 48 offices across the U.S. and 2 India



# Agenda

1. Opportunity Zones 101
2. QOF & QOZB Updates
3. Gain Deferrals & Investing in a QOF
4. Other Real Estate Updates
5. Questions

01. Opportunity

Zones 101



## Opportunity Zones 101

- Taxpayer has “capital gain” from an actual or deemed sale or exchange of property or any other gain included in the calculation of capital gain for federal income tax purposes
- The sale or exchange of property must be with an unrelated third party (20% standard applies rather than normal 50%)
- Gain can be from personal, business, or investment property
- Taxpayer reinvests that capital gain into a Qualified Opportunity Fund (QOF) within 180 days of the transaction triggering the gain

# Opportunity Zones 101

- Federal tax benefits for investor:
  - ▶ Deferral
    - Investors can make an election for their reinvested capital gain to be deferred until *earlier* of:
      - When they sell their QOF investment
      - December 31, 2026
  - ▶ Basis Step Up
    - Five years, their *original deferred capital gain* is reduced by 10%
    - Seven years, their *original deferred capital gain* is reduced by another 5% -Expired at 12/31/2019
  - ▶ Exclusion
    - Ten years= If taxpayers elect, no taxable gain is recognized on the sale of their *QOF investment* (their tax basis in the QOF investment is deemed to be equal to its FMV as of the date of sale), but a taxable loss can still be recognized
      - This 10-year hold benefit is not impaired solely because the designation of opportunity zones ceases to be in effect on December 31, 2027
      - The taxpayer remains eligible for the 10-year hold benefit until December 31, 2047

## Sample Fund Investment – Investor Tax Benefits



- January 2, 2019:  
Taxpayer realizes a \$1M capital gain
- June 30, 2019:  
Within 180 days, the taxpayer invests that \$1M of capital gain into a fund

Taxpayer is deemed to have a \$0 beginning basis in the fund investment

Fund Invests the \$1 M in Qualified Opportunity Zone Property



## Sample Fund Investment – Investor Tax Benefits



- June 30, 2024:  
After five years, taxpayer's basis in fund investment increases from \$0 to \$100K, which is 10% of \$1M original investment

- June 30, 2026:  
After seven years, taxpayer's basis in fund investment increases from \$100K to \$150K, which is 15% of \$1M original investment

- December 31, 2026:  
Remaining \$850K of the original \$1M of deferred capital gain is taxed.

Taxpayer's basis in fund investment increases from \$150K to \$1M.

## Sample Fund Investment – Investor Tax Benefits



- June 30, 2029:  
After 10 years, taxpayer sells fund investment for \$3M. Taxpayer elects for basis to be deemed equal to FMV; therefore, taxpayer has \$0 gain on sale of fund.

# Opportunity Zones 101

- A fund can be a:
  - ▶ Corporation (C or S),
  - ▶ Partnership, or
  - ▶ LLC that is taxed as either a corporation or partnership
- The fund entity must hold at least 90% of its assets in Qualified Opportunity Zone Property (QOZP) which is the following:
  - ▶ **Qualified Opportunity Zone Stock or Qualified Opportunity Zone Partnership Interest**
    - Equity interest must be in a new or existing partnership/corporation
    - Equity interest must be acquired by fund after December 31, 2017
    - Equity interest must be acquired for cash
    - Stock in a corporation must be original issue, not acquired from another investor in the corporation
    - Must be a QOZ Business at the time the interest is issued and for 90% of the QOF's holding period of the interest.



# Opportunity Zones 101

- The fund entity must hold at least 90% of its assets in Qualified Opportunity Zone Property (QOZP) which is the following:
  - ▶ Direct investment in Qualified Opportunity Zone Business Property (QOZBP)
    - Tangible property that is used in the trade or business of the QOF or QOZ business
    - The property must be acquired by purchase from an unrelated party (20% standard applies rather than normal 50%)
    - Property must be acquired after December 31, 2017
    - The “original use” of the property within the QOZ must commence with the QOF or Substantial” improvements must be made to the property
    - *70% of the use must be in an opportunity zone during 90% of the holding period*

# Qualified Opportunity Zone Business

- Substantially all (70%) of the trade or business's tangible property, owned or leased, is QOZB Property
- A substantial portion of its intangible property is used in the active conduct of the trade or business in an opportunity zone (40%)
- Less than 5% of the average of the aggregate unadjusted basis of its property is attributable to nonqualified financial property
  - ▶ An exception is made for reasonable amounts of working capital held as cash, cash equivalents or debt for 18 months or less
- A least 50% of its total gross income is derived from the active conduct of its trade or business in the qualified opportunity zone
  - ▶ *Safe harbor #1:* 50% of the services performed for the business by its employees and independent contractors (and employees of independent contractors) are performed in the qualified opportunity zone, based on amounts paid for the services performed
  - ▶ *Safe harbor #2:* 50% of the services performed (based on hours) for such business by its employees and independent contractors (and employees of independent contractors) are performed within the qualified opportunity zone
  - ▶ *Safe harbor #3:* 50% of the gross income requirement is met if (1) the tangible property of the business that is in a qualified opportunity zone and (2) the management or operational functions performed for the business in the qualified opportunity zone are each necessary to generate 50 percent of the gross income of the trade or business.

# Qualified Opportunity Zone Business

- No “Sin” businesses
  - ▶ Massage parlors
  - ▶ Golf courses
  - ▶ Liquor stores
  - ▶ Casinos



A photograph of three construction workers in profile, looking towards the right. The worker in the center is a Black man wearing a yellow hard hat with an orange chin strap and clear safety glasses. He is wearing a green collared shirt. To his left is a white man in a white hard hat and safety glasses. To his right is a white man with a beard, wearing a white hard hat and safety glasses. The background is dark and out of focus.

02. QOF & QOZB

Updates &

Clarifications

## Working Capital Safe Harbor for QOZBs

- In General – For each taxable year, less than 5% of property can be attributable to nonqualified financial property
- Working Capital Safe Harbor – Working capital is treated as reasonable in amount if the following requirements are satisfied
  - ▶ Designated in writing
  - ▶ Reasonable written schedule – Consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital must be spent within 31 months of the receipt by the business of the assets
  - ▶ Property consumption consistent – The working capital assets are actually used in a manner that is substantially consistent with the written schedule



## Working Capital Safe Harbor for QOZBs

- Overlapping 31-month working capital safe harbors allowed with respect to the same piece of tangible property
  - ▶ Multiple safe harbors allowed, but cannot extend beyond 62-months total
  - ▶ To qualify for a maximum 62-month safe harbor period, a start-up business must receive multiple cash infusions during its start-up phase
  - ▶ The subsequent cash infusion must be independently covered by an additional working capital safe harbor
  - ▶ The working capital safe harbor plan for the subsequent contribution must form an integral part of the first plan
  - ▶ Time clock starts upon initial cash infusion

# Working Capital Safe Harbor for QOZBs

- Government Delays
  - ▶ If a governmental delay has caused the delay of a project covered by the 31-month working capital safe harbor, and no other actions could be taken to complete the project during the permitting process, then the working capital safe harbor will be tolled for a duration equal to the delay
- Uncertainty if cash held as working capital counts as QOZBP for asset testing purposes
  - ▶ Preamble suggests cash should qualify
  - ▶ Regulatory language suggests cash doesn't qualify as QOZBP until cash is spent
- Tangible property purchased, leased, or improved by the trade or business, pursuant to the working capital plan is treated as QOZBP

# QOF Testing Safe Harbor and QOZB Cure Period

- QOFs may disregard recently contributed property
  - ▶ The final regulations provide a QOF a 6-month period in which QOFs may choose to disregard recently contributed property from the 90-percent asset test
  - ▶ This rule may be elected in circumstances in which a QOF is unable to deploy its capital into QOZP by the testing date
- Cure period for QOZBs
  - ▶ The final regulations provide a 6-month period for an entity in which a QOF has invested to cure a defect that caused the entity to fail to qualify as a QOZB
    - During the 6-month cure period, the QOF can still treat the entity as a qualifying QOZB
    - A QOZB can utilize the 6-month cure period only once

## 30-Month Substantial Improvement Period

- During the 30-month substantial improvement period, eligible tangible property in the process of being improved but not yet placed into service is treated as satisfying the substantial improvement requirement
  - ▶ For property to be eligible for this safe harbor, there must be a reasonable expectation that the property will be substantially improved and used by the QOF or QOZB no later than the 30-month substantial improvement period

## Substantial Improvement Test

- The final regulations set forth an asset aggregation approach for determining whether a non-original use asset (such as a preexisting building) has been substantially improved.
- The final regulations, QOFs and qualified opportunity zone businesses can take into account purchased original use assets that otherwise would qualify as qualified opportunity zone business property if the purchased asset:
  - ▶ Are used in the same trade or business in the QOZ (or a contiguous QOZ) for which the non-original use asset is used, and
  - ▶ Improve the functionality of the non-original use assets in the same QOZ (or a contiguous QOZ)

# Substantial Improvement Test

- The final regulations require that the purchased property must be improved by more than an insubstantial amount.
- Finally, if an eligible entity chooses to use this approach, the purchased property will not be treated as original use property, and instead, the basis of that purchased property will be taken into account in determining whether the additions to the basis of the non-original use property satisfy the requirements
  - ▶ **Hotel Example:**
    - QOF purchases and intends to substantially improve a hotel
    - The QOF may include “original use” purchased assets in the basis of the purchased hotel to meet the substantial improvement requirement if those purchased assets are integrally linked to the functionality of the hotel business
    - These “original use” purchased assets could include mattresses, linens, furniture, electronic equipment, or any other tangible property.

## Improvements to Non-Qualifying Property

- Improvements made to non-qualified property used in a QOZ do NOT satisfy the original use requirement.
- If property otherwise qualifies as qualified opportunity zone business property, the fact that the property is constructed on leased land will not disqualify the property from being treated as qualified opportunity zone business property.
- Property contributed by an entity to a QOF, while potentially used in the QOF's trade or business, will not be considered qualified opportunity zone business property because the QOF has not purchased, leased, or self-constructed the contributed property.

## Asset Aggregation of certain buildings as a single property

- For purposes of applying the substantial improvement requirement, certain buildings can be aggregated and treated as a single item of property the final regulations address eligible building groups located entirely within a parcel of land described in a single deed, as well as groups spanning contiguous parcels of land described in separate deeds.
- First, a QOF or QOZ business may treat all buildings that compose an eligible building group and that are located entirely within the geographic borders of a parcel of land described in a single deed as a single property



## Asset Aggregation of certain buildings as a single property

- Second a QOF or QOZ business may treat all buildings composing an eligible building group that are located entirely within the geographic borders of contiguous parcels of land described in separate deeds as a single property to the extent each building is operated as part of one or more trades or businesses that meet the following three requirements:
  - ▶ The buildings must be operated exclusively by the QOF or by the qualified opportunity zone business
  - ▶ The buildings must share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources
  - ▶ The buildings must be operated in coordination with, or reliance upon, one or more of the trades or businesses

## Triple Net Leases

- The ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer.

# Leased Property

- In order for leased property to meet the definition of QOZBP they must meet the following criteria:
  - ▶ Lease must have been entered into after 12/31/2017
  - ▶ Substantially all (70%) of the use of the leased property must be in an opportunity zone substantially all (90%) of the period for which the business leases the property
  - ▶ Lease needs to be a market rate lease
- The regulations do not impose an original use requirement with respect to leased tangible property or a requirement for a lessee to “substantially improve” leased tangible property
- The regulations provide that improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property

# Leased Property

- The proposed regulations allow for the lessor and lessee to be related parties (with further limitations):
  - ▶ The QOF or QOZB are not allowed to make a prepayment to the lessor that exceeds 12 months
  - ▶ Leased tangible personal property is not treated as QOZBP unless the lessee becomes the owner of tangible property that is QOZBP and that has a value not less than the value of the leased personal property.
  - ▶ Anti-abuse rule

# Leased Property

- Valuing Lease
  - ▶ The final regulations clarify the rules to be used to determine the AFR for a particular lease, and provide that the short-term AFR must be used. The Treasury Department and the IRS have determined that use of the short-term AFR will provide a simple and objective rule for taxpayers and practitioners
  - ▶ The term of a lease that is being valued for purposes of the 90-percent investment standard includes periods during which the lessee may extend the lease at a pre-defined rent. The terms of a pre-defined market rate rent must follow the criteria set forth under section 482 with a rebuttable presumption that terms of a lease between unrelated parties is market rate

## Debt Financed Distributions

- Regulations generally allow a QOF partnership to make debt-financed distributions
  - ▶ Examples are included in the regulations to help demonstrate how this works
  - ▶ On September 24, 2019, Alan and Bob form Opportunity Fund, a QOF partnership, each contributing \$200 that is deferred under the section 1400Z-2(a) election to Opportunity Fund in exchange for a qualifying investment. On November 18, 2022, Opportunity Fund obtains a nonrecourse loan from a bank for \$300. Under section 752, the loan is allocated \$150 to Alan and \$150 to Bob. On November 30, 2022, when the values and bases of the investments remain unchanged, Opportunity Fund distributes \$50 to Alan.
    - Joe is not required to recognize gain under §1.1400Z2(b)-1(c) because Joe's basis in its qualifying investment is \$150 (the original zero basis with respect to the contribution, plus the \$150 debt allocation). The distribution reduces Joe's basis to \$100.

## Debt Financed Distributions

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  - ▶ Examples are included in the regulations to help demonstrate how this works
  - ▶ On September 24, 2019, Alan and Bob form Opportunity Fund, a QOF partnership, each contributing \$200 that is deferred under the section 1400Z-2(a) election to Opportunity Fund in exchange for a qualifying investment. On November 18, 2022, Opportunity Fund obtains a nonrecourse loan from a bank for \$300. The loan is entirely allocated to Bob under section 752. On November 30, 2024, when the values of the investments remain unchanged, Q distributes \$50 to Alan.
    - Alan is required to recognize \$30 of eligible gain under section §1.1400Z2(b)-1(c) because the \$50 distributed to Alan exceeds Alan's \$20 basis in its qualifying investment (the original zero basis with respect to its contribution, plus \$20 with regard to section 1400Z-2(b)(2)(B)(iii)).



03. Investing  
in a Qualified  
Opportunity Fund



## §1231 Gains

- §1231 Gain Definition – Gain arising from the disposition of property that is used in a trade or business
  - ▶ Example: rental real estate
  - ▶ §1231 gains and losses generally netted as of last day of tax year to determine character
- Final Regulations – Take the gross approach solely with regard to eligible §1231 gains
  - ▶ Timing for 180 day reinvestment period now begins on date of sale or exchange
  - ▶ Income recaptured as ordinary income (such as depreciation recapture) does not qualify as eligible capital gain for reinvestment
  - ▶ Special gain inclusion rule under §1231(c) still applies when gain realized

# Gain Deferral – Flow-Through Entities and Installment Sales

## ■ Partners & S Corporation Shareholders

- ▶ Have the option to treat the 180-day reinvestment period as commencing on:
  - The day of the sale or exchange
  - The last day of the entity's tax year
  - The due date of the entity's tax return, not including any extensions

## ■ Installment Sales

- ▶ Have the option to treat the 180-day reinvestment period commencing on:
  - The date a payment under the installment sale is received
  - The last day of the taxable year the eligible gain would have been recognized
- ▶ Include gains realized from the sale of property prior to December 2017

# Exit Strategy & Eligible QOF Interests

- Gain Exclusion for Asset Sales
  - ▶ The final regulations clarified in the case of QOF partnerships and S corporations that the disposition (or partial disposition) of QOF and QOZB assets will qualify for gain exclusion if it meets the 10-year holding period and other requirements
  - ▶ Applies to all assets except inventory
  - ▶ FMV is equal to the actual sales price when buyer and seller are unrelated
- Sale of Interest in QOF Partnership
  - ▶ Basis of partnership assets are adjusted to FMV at QOF and QOZB regardless if §754 election in place
- Eligible QOF Interests - Final regulations do not require the transferor to have a qualifying investment

# Inclusion Events

- Definition – Certain events (with some exceptions) result in the inclusion of gain under the regulations to the extent that:
  - ▶ The event reduces an eligible taxpayer's direct equity interest in the qualifying investment;
  - ▶ A taxpayer receives property in a transaction treated as a distribution for Federal income tax purposes, regardless of whether the receipt reduces the taxpayer's ownership of the QOF
  - ▶ A taxpayer claims a worthless stock deduction with respect to its qualifying investment
- Generally results in a reduction or termination of qualifying investment status
- QOF Partnerships
  - ▶ The final regulations provide that a distribution by a QOF partnership to a partner is an inclusion event to the extent the distribution is of cash or property with a FMV in excess of the partner's outside basis
- Gain arising from an inclusion event is eligible for reinvestment in a QOF

# Transfer of Interest by Death or Divorce

- Death

- ▶ Does not trigger an inclusion event
- ▶ Final regulations provide that the tax on the decedent's deferred gain is the liability of the person in receipt of the interest from the decedent

- Divorce

- ▶ Transfer of a qualifying investment between spouses incident to divorce constitutes a disposition of the interest and therefore is an inclusion event
  - The transferor's deferred gain is recognized and the transferee's interest in the QOF is no longer a qualifying investment

04. Other

Real Estate

Updates



## Unimproved land

- Unimproved land located within a QOZ and acquired by purchase is not required to be substantially improved
- QOFs and QOZBs should improve land by more than an insubstantial amount.
  - ▶ No specific or Brightline test exists
  - ▶ Examples: Improvements to the land, such as an irrigation system for a farming business or grading of the land with a sufficient nexus to a trade or business of the QOF or qualified opportunity zone business, as more than an insubstantial amount of improvement.
  - ▶ IRS also includes examples of when anti-abuse rules would come into play for “land banking”

## Vacant Property

- The final regulations provide a special one-year vacancy requirement for property that was vacant prior to and on the date of publication of the QOZ designation notice that listed the designation of the QOZ in which the property is located, and through the date on which the property was purchased by an eligible entity.
- If property was not vacant at the time of QOZ Designation, but becomes so later, the property must be vacant for a period of three years continuously
- A three-year vacancy period for property that was not vacant at the time of QOZ designation will more effectively facilitate such investment while alleviating concerns that QOFs and qualified opportunity zone businesses would intentionally cease occupying property to convert otherwise used property into “original use” property



## Vacant Property

- Real property, including land and buildings, is considered to be in a state of vacancy if the property is “significantly unused.” A building or land will be considered to be “significantly unused” under the final regulations if more than 80 percent of the building or land, as measured by the square footage of useable space, is not being used. If property was not vacant at the time of QOZ Designation, but becomes so later, the property must be vacant for a period of three years continuously
- The final regulations provide that an eligible entity that purchases real property from a local government that the local government holds as the result of an involuntary transfer (including through abandonment, bankruptcy, foreclosure, or receivership) may treat all property composing the real property as satisfying the original use requirement

## Real Estate Updates – Self-Constructed Property

- The 90-percent investment standard and the 70-percent tangible property standard, self-constructed property will be treated as acquired on the date physical work of a significant nature begins
- Physical work of a significant nature does not include preliminary activities such as planning or designing, securing financing, exploring or researching, and will depend on a facts and circumstances analysis
- Safe Harbor: An eligible entity may choose the date on which the eligible entity paid or incurs more than 10 percent of the total cost of the property, excluding the cost of any land and preliminary activities such as planning and designing, securing financing, exploring or researching.



## Questions

How can we help?

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