Deep Dive: Final Opportunity Zone Regulations Explained

Executive Summary. Over the holiday break, the US Treasury Department released final guidance on the Opportunity Zones incentive. That final guidance was published in the Federal Register on January 13, 2020. To spare you from reading 136 pages of final text, Opportunity Alabama has compiled a comprehensive summary of the new regulations.

Among the key takeaways for interested parties are the following:

- Investors with gains from sale of tangible property used in the course of a trade or business (1231 gains) have a much clearer path to investment.
- Additional guidance around qualifying operating businesses for investment has created an even clearer pathway for OZ investment in startups and existing businesses.
- Operating businesses and major real estate developments now have a longer deployment cycle (up to 62 months) to spend down capital raised.
- Developers of vacant property and brownfield sites have significant new advantages when it comes to qualifying their projects for potential OZ investment.
- Developments straddling a boundary between an OZ and a non-OZ now have an interesting new path to becoming a qualified OZ business.
- Businesses with multiple assets may now find it far easier to meet the "substantial improvement" test because of new property aggregation rules.

Most important, the final regulations set a lasting roadmap for how to navigate the Opportunity Zones incentive in the coming years. The uncertainty around investment in certain asset classes (like operating businesses or large-scale development projects) is now gone, leaving investors with a clear pathway towards investment.

To learn more about how these final regulations could impact you, please contact us.

The Final Regulations: OPAL Summary

Introduction. The Treasury Department published the final set of Opportunity Zone regulations on Dec. 19, 2019. These regulations build upon two prior sets, released in October 2018 and April 2019, respectively. In this article, we'll synthesize the final regulations together with the previous rounds to present you with a comprehensive overview of how the Opportunity Zone incentive will work going forward.

Basic Setup. Every Opportunity Zone (OZ) investment has three components: someone with a capital gain (the investor), a fund (called an "Opportunity Fund"), and an investment opportunity (called a "Qualified Opportunity Zone Business" or "QOZB"). We'll discuss how the regulations impact each of these three component parts in sequence below. **A note to readers - if you do not have your own capital gain and are only curious about what the final regulations say about forming a qualified OZ business, skip to Part 3.**

Part 1: Opportunity Fund Investors

We have heard three primary questions from OZ investors: "what do I get from investing", "who can invest / what can I invest", and "how long do I have to invest it"? We address each question in sequence below.

Section 1A: Benefits of OZ Investing. There are three primary benefits from investing in an Opportunity Fund:

(1) *Temporary deferral* of capital gains tax on the invested gain —until either December 31, 2026 or when you decide to sell your Opportunity Fund investment (whichever comes first).

(2) A *potential* 10% capital gains tax reduction on what you invested into the Fund. This is what some call the "Five Year Step-Up in Basis" and is explained in detail below.

(3) A *total elimination* of capital gains taxes on what you *make* on your Opportunity Fund investment. There is also the potential to eliminate depreciation recapture at sale, as discussed below.

Benefit (2) gets confusing, so we'll put it like this: If you have been holding your OZ investment for at least 5 years by the time you are due taxes on your original gain, you automatically receive a 10% discount on *what you would have owed*. Most investors want to be invested in an OZ investment for at least 10 years to claim Benefit (3). Thus, anyone who puts money into an

Opportunity Fund *before December 31, 2021* will get a 10% discount on their original gain tax bill when it comes due on December 31, 2026. One key note, however: final regulations confirmed that the tax owed on capital gains in 2026 is calculated using whatever capital gains tax rate is in place at the time, *not* the one in place today.

EXAMPLE 1A: In 2020, Sue sells stock she originally bought for $200,000 for $1 million. She makes $800,000. She decides to pay tax on $300,000 of that gain, and invest the rest—$500,000—into an Opportunity Fund. She does not owe any tax at all on the $500,000 until Dec. 31, 2026 (assuming she does not sell earlier), and—assuming she is taxed at a 20% capital gains tax rate—she only owes $90,000 in taxes (10% less than the $100,000 she would otherwise owe).

Benefit (3) is what attracts most people to OZ investment. The final regulations confirm that an investor's basis in an Opportunity Fund investment equals its fair market value (typically, its sale price) when it is sold. With tax equal to sales price minus basis, the resulting tax will always be zero. For more on this, see the example below and the discussion of "Fund Unwind" under Part 2—Opportunity Fund Issues.

EXAMPLE 1A (Con't): Assume Sue, from the example above, holds onto her investment until 2030—which is more than 10 years from when she made it. Further assume that she can sell her $500,000 investment for $1.5 million, and that she has taken $150,000 in depreciation deductions over the last 10 years. When she sells, she does not have to pay capital gains taxes on the $1 million she made *or* depreciation recapture on the $150,000 she wrote down.

Section 1B: Who Can Invest and What Can They Invest? The only group that can receive direct tax benefits from investing into Opportunity Funds are investors with US-based capital gains. Here's what that means – and what it doesn't:

- Ordinary income (e.g., money sitting in a savings account) will not get any of the OZ benefits described in Section 1A above, including the 10-year hold benefit.
- Any entity with capital gains can invest, from individuals to corporate groups.
- Foreign taxpayers with US capital gains can invest.
- Many institutions—like state pension funds, community foundations, or university endowments—will not have taxable capital gains. However, there are two big reasons they should stay engaged in the conversation:
    - Capital gains subject to unrelated business income tax (UBIT) *are* eligible for OZ investment, and many of the above entities have large, recurring sources of capital gains-treated UBIT; and

- Even for entities without UBIT, there is no prohibition on investing in OZs. In fact, many anchor institutions are making program- and mission-related investments into Opportunity Funds knowing they will not receive tax benefits for doing so because those funds have a strong impact thesis which aligns with the institution's goals and objectives. This non-OZ capital is critical to making a multi-tiered Opportunity Fund work.

If investors don't have gain at the time but suspect they might in the future, there is a potential workaround. See "Fund Structuring" under Section 2A below for more details.

One big advance in the new round of regulations is a comprehensive suite of regulations for how companies that are part of a combined group can make OZ investments. If you are part of a combined group or want to know how these regulations could impact you, please reach out to us.

Section 1C: How Long Do Investors Have? The general rule is that investors have 180 days from when the gain event occurs to invest some (or all) of that gain into an Opportunity Fund. There are, however, a number of critical exceptions:

- *Pass-Through Entities* (like LLCs taxed as partnerships, S-Corporations, or beneficiaries of estates): These investors have *either* 180 days from the date the partnership had the gain *or* 180 days from the end of the entity's tax year, whichever works better for the investor.
- *1231 Gains:* The IRS created a special set of rules for gains arising from the sale of real or depreciable business property, common among real estate developers. Typically, 1231 gains ("gross gains") are netted against 1231 losses ("gross losses") at the end of the year to come up with the appropriate taxable amount. The final regulations clarify that taxpayers have 180 days from whenever a gain event occurred and can invest the full gross gain amount into an Opportunity Fund without worrying about gross losses or end of year netting. This is a highly favorable rule change from the April 2019 regulations.
- *RIC or REIT Gains*: Shareholders in RICs or REITs get 180 days from *either* (i) the time they receive a capital gain dividend *or* (ii) 180 days from the end of their tax year.
- *Installment Sales*: Sellers who have sold an asset for a series of recurring payments have *either* (i) a one-time 180 day window after the end of the seller's tax year (in the year of the sale) to invest the full gain amount *or* (ii) 180 days after the seller receives each installment check.
- *Virtual Currency*: Gains on virtual currency can be invested just like any other gains, within 180 days of when they occurred (unless they came from a pass-through entity).

Remember that this first timing window just marks the period during which an investor has to invest in an Opportunity Fund. As discussed below, funds have 6-12 months from when they receive capital to put that money to work on an investment. So, don't think you need to have projects under construction or be closing a startup investment 180 days from your gain event.

Part 2: Opportunity Funds

Every investor needs to put their gains into an Opportunity Fund in order to qualify for the favorable tax treatment described in Part 1. This Part explains how to form and administer those funds.

Section 2A: Fund and Investor Structuring. An Opportunity Fund is a special-purpose investment vehicle that must be taxed as either a partnership or a corporation (meaning it can be an LLC, as long as it is treated as a partnership or corporation for tax purposes). Anyone can form or manage an Opportunity Fund, including nonprofits and public entities—though anyone forming a fund will need to be very careful about compliance with existing securities law (see below).

To date, many of the funds we have seen created are "single-investor" funds. For example, Sue (our investor from above) could form her own Opportunity Fund using her own capital gain event and have complete discretion over where she deploys her money. In other words – while there are plenty of great regional and national Opportunity Funds managed by investment professionals, you ultimately need nothing more than a lawyer, an accountant, and a helpful guiding agent like Opportunity Alabama to form your own fund.

Investments into funds can be structured as either equity or debt. If structured as equity <u>and</u> sourced from capital gains, investments will get all the OZ benefits described in Section 1A. If structured as debt or equity sourced from ordinary income, investments will not get <u>any</u> of the OZ benefits. However, the final regulations allow debt investments to be "replaced" by equity investments down the road. This opens the door to "placeholding" OZ investments with debt.

Section 2B: Fund Deployment Timing and Testing. Once an investor forms an Opportunity Fund, they must ensure that 90% of their assets are invested in stock or partnership interests of "qualified Opportunity Zone businesses" (or directly into qualified OZ property). We refer to this as the "90% Investment Test." We'll cover what it means to be a "qualified OZ business" in Part 3. For now, let's explore the timing requirements around forming a fund and deploying capital.

Funds must meet the 90% Investment Test twice a year—on June 30 and December 31. Fortunately, funds get to skip the first testing window after formation if they are still just holding cash or cash equivalents from a recent capital call. In other words, say an investor has a gain event in May 2020, and decides to form and fund their own Opportunity Fund in November 2020. That fund would likely still be holding nothing but cash on December 31, 2020—so the fund won't be required to meet the 90% Investment Test until June 30, 2021. This gives the investor ample time (from May 2020 to June 2021) to close one or more investments into one or more qualified OZ businesses.

For the duration of the Opportunity Fund's holding period, it will need to meet the 90% test twice a year. One big question prior to the final regulations was how a fund that invests in businesses with shifting asset bases—like an expanding manufacturing company—would meet this test. For example, what would happen if a business was a qualified OZ business in June, had too many unqualified assets to meet the test in September, but shed those assets and came back into compliance by December?

The regulations provide a new safe harbor to meet this 90% test. Businesses only need to be "qualified OZ businesses" as of the *end of their respective tax years*—and funds can continue to rely on that for the next testing windows. For example, if a business has a fiscal year end in September and is qualified as of that date, it would be considered qualified OZ business property in the hands of an Opportunity Fund for both the December 90% Test *and* next June's 90% Test.

Even if a business fails this test, there are two fallback provisions:

- If a business fails to be qualified as of a test date, the business gets a one-time 6-month cure period (until the next test date).
- If the cure period has already been used, a fund may still be able to avoid the typical penalty for investing in non-qualified OZ businesses if it can show "reasonable cause" as to why it could not keep the business in compliance or shed the investment.

Section 2C: Disposing of Fund Interests During Holding Period. As described above, most OZ investors want to hold their investments into Opportunity Funds for 10 years or longer. However, investors *can* dispose of their interests in the Opportunity Fund at any point during the holding period (as long as they can find a willing buyer).

There are certain instances when an OZ investor "transfers beneficial ownership" of their interest in the Opportunity Fund, whether they intend to do so or not. These events - discussed below - could cause an unplanned tax liability.

- *Deemed Transfers*. There is a laundry list of actions in the regulations that reduce an investor's direct equity interest in an Opportunity Fund and—as a result—are deemed a "transfer," ending the investor's holding period and causing an inclusion of the OZ-deferred capital gain. These include gifts, Section 351 exchanges, transfers into most types of trusts (except grantor trusts), certain kinds of C-corp stock redemptions, and more. A couple of common exceptions are discussed below. Contact us for more details if you are concerned that your transaction may create an inclusion event.
- *Taking Distributions (Including Debt-Financed Distributions).* Opportunity Funds can make distributions to investors during the 10-year holding period—as long as those distributions do not "constitute an impermissible 'cashing out' of a qualified investment." This means that funds can distribute loan proceeds, earnings, or sale proceeds to investors *as long as those distributions do not exceed the investor's basis in the Opportunity Fund*. Because every investor starts with a zero basis in an Opportunity Fund, investors need some kind of basis before they can take distributions. This is why debt-financed distributions work well in the OZ partnership context—the debt provides investor partners with basis against which to take debt-financed distributions.

Estate Planning and Transfers at Death. If an Opportunity Fund investor dies while holding their interest, it does not trigger a taxable event. The heirs step into the shoes of the decedent Opportunity Fund investor, taking over the same holding period. This means that the heirs do *not* get to step up their Opportunity Fund interests to fair market value at the time the OZ investor dies (as is typical of other kinds of inherited property).

Section 2D: Interim Gains on Sales During Holding Period. Assume an investor puts $1 million of deferred capital gains into an Opportunity Fund to acquire a high-growth OZ business in 2020. Further assume a private equity group shows up in 2024 and offers $50 million for the business. The investor decides to sell. What happens to the $1 million in original gain and the $49 million in new capital gains?

- Original $1 million: Our investor has 6 months to redeploy the gain into another qualified investment. If done, our investor can continue deferring capital gains taxes on the $1 million until December 31, 2026.
- New $49 million in gain: Because our investor did not hold the business until 2029 (10 years), they will need to pay capital gains tax on the $49 million in 2024 *unless they decide to roll the $49 million in gain into a new Opportunity Fund*. This Opportunity Fund would have a start date in 2024 – meaning the deferral on the $49 million in gain would only last two years (until 2026) and the new Opportunity Fund would have

to hold onto its new $49 million in acquisitions until 2033 to get the full 10-year holding period benefit.

Section 2E: Unwinding an Opportunity Fund. When an investor is ready to "cash out" in Year 10 or later, investors can elect to exclude any gain from any sale of property made by the qualified OZ business ***or*** the Opportunity Fund itself. Once made, this election remains in place until all the fund's property is disposed—meaning that an unwind can take place over months or years and an investor will not have to worry about paying any capital gains associated with the unwind.

Technically, all OZ investments made before the zone designations expire in 2028 must be unwound by 2047 – the date set by Treasury as the outside date for claiming the 10-year holding period benefit. In the preamble to the final regulations, Treasury suggests that they will be extremely flexible with their approach to this date, either by granting anyone still invested after 2047 with an automatic basis step up to 2047 value or potentially extending the arbitrary 2047 date.

Section 2F: Certification and Reporting Requirements. Two forms - IRS Form 8996 and 8997 - govern fund reporting and compliance. Unfortunately, the enhanced reporting requirements many commenters requested did not make it into the final regulations, leaving it to Congress to provide us with more data about how investors are using this incentive.

Section 2G: Securities Law Compliance. Anyone thinking about forming an Opportunity Fund needs to remember that there is an entire body of securities law that governs fund formation and investor solicitation. Last summer, the SEC released a staff comment letter on the interrelationship between Opportunity Funds and SEC compliance. Securities law compliance is one of the many reasons to carefully consult the appropriate professionals before making an OZ investment.

Part 3: Qualified OZ Businesses

Opportunity Funds need to invest at least 90% of their assets in "qualified Opportunity Zone businesses" or directly into qualified OZ business property. Because the vast majority of funds will be investing in businesses, not directly buying property, we'll focus on those sets of regulations. There are some critical differences, though, which we are happy to explain on an individual basis if you intend to buy business property through an Opportunity Fund.

There are seven tests a business must meet to be a qualified OZ business:

ASSET TESTS: 70% of the business' tangible property must –

(A) be acquired after 2017 from an unrelated party,
(B) be "used" in any OZ 70% or more of the time, and
(C) be "original use" property or be substantially improved.

OPERATING TESTS: A business must –

(D) get 50% of its revenue from "active conduct" in any OZ,
(E) use 40% or more of its intangible property in any OZ,
(F) not hold "non-qualified financial property," and
(G) not operate a "sin business."

Each Section below explores one of these seven tests in detail.

Section 3A: Acquiring Assets After 2017. In general, 70% of the tangible assets (including land, buildings, equipment, and more) of the operating business need to be acquired after 2017 from an unrelated party. While new businesses and existing businesses looking to significantly expand don't typically have issues with this test, existing businesses with lots of assets or developers who have owned property for a long period of time will sometimes have difficulty with this provision.

There are a few regulatory workarounds in the final regulations:

- Adding 70% New Property: Assume a developer has owned land and a building worth $300,000 since 2010, and wants to use her own capital gains to place the property back into service. As long as she has $700,000 worth of new tangible property (e.g., sticks, bricks and mortar) she plans to acquire from unrelated parties (like Home Depot or her general contractor) to make the necessary improvements, then 70% of the overall value of the project will be new property bought after 2017 once construction is complete, and the *whole project* (not just the new sticks, bricks and mortar) should qualify.
- Leasing: Property acquired by lease after December 31, 2017 satisfies the "post 2017 acquisition test"—and leases can even involve transfers between related parties. See Section 3C(4) below for additional details.

These workarounds get complicated quickly (particularly when they involve related parties), so contact us if you are considering an OZ investment into a business that will likely have this issue.

Section 3B: "Use" of Assets in an OZ. In general, 70% of the tangible assets of the business (excluding inventory) need to be "in use" at least 70% of the time in <u>any</u> Opportunity Zone. Here are a few details and extensions of this test:

- "In use" in an OZ means (i) located within the geographic borders of any OZ and (ii) used to make money in trade or business. The relevant metric is the *number of days between the two 180-day testing periods* in which this is true. There are two safe harbors built into this definition, which we call the "delivery truck" and "U-Haul" exceptions.

  - Delivery Truck Safe Harbor: up to 20% of a business' property *automatically passes* the "in use" test if: the business (i) has an office in an OZ, (ii) manages the employees using the property in question from an OZ office, and (iii) does not let the property in question stay out of an OZ for more than 14 consecutive days.
  - U-Haul Safe Harbor: Leasing businesses (like U-Haul or an equipment rental shop) qualify if (i) the equipment is normally parked in the OZ when not in use and (ii) the typical lease duration does not exceed 30 days.
- "In use" is an asset by asset determination. Thus, real property-heavy businesses (e.g., single-purpose real estate development companies) typically have an easier time meeting this test than operating companies with lots of moving assets like vans or laptops.

One common question we receive is: "my property is just across the street from an OZ or just down the road—how can I get it included?" The final regulations give us a few helpful pointers:

- If your property is adjacent to the OZ but separated by a geographic boundary (e.g., a "road, street, railroad, stream, or similar boundary"), you are allowed to treat *all of the property as qualified* if you buy and improve land or a building in the adjacent OZ. The OZ land or building must be greater than or equal to the non-OZ land or building, as measured by square feet or by unadjusted cost at time property is acquired. Critically, there must be a common owner and common development plan for this test to work.
- If your property is not contiguous to an OZ, it could still be part of a broader OZ development plan and fit within the "located anywhere" bucket referenced above. In other words, if a common development plan led by a single qualified OZ business includes two properties in an OZ worth $7 million and one property outside the OZ worth $3 million, the business is a QOZB because 70% of its property is "in use" in the Zone.

Section 3C: Original Use, Substantial Improvement, and Leasing. 70% of all tangible property owned by a QOZ business either needs to be "original use" or "substantially improved"—with significant carve-outs for how raw land and leased property fit into the equation. We discuss how to meet each of those tests below. If your project involves a lease or a substantial amount of raw land, read those sections first—then contact us to make sure you fully understand the ramifications for your project.

Section 3C(1): Original Use. "Original use" property is any tangible property that has not been depreciated *in any Opportunity Zone*. This definition, plus a few Treasury-created exceptions, give rise to the following categories of "original use" property:

- *New Tangible/Personal Property*. All "new from the factory property" plus any property *not used in an OZ* before.
- *Business Equipment Moved Into an OZ*. Any business that *moves into the OZ* for the first time will automatically have all of its equipment qualify as "original use" because, even though it has been in use for years, it has never before been "depreciated in the OZ."
- *Ground-Up Construction*. As discussed below, land gets special treatment within the "original use / substantial improvement" test: it is basically ignored, and any new building built from the ground up will be considered "original use" property. As a result, an OZ investor can put capital into a project *any time before it is placed into service*, after which the property is no longer deemed "original use."
- *Vacant Property*. Any existing structure that has at some point in its life been placed into service is no longer original use and must be "substantially improved," as explained below. However, the final regulations create a special carve-out for vacant property, which is *deemed to be original use*—and thus does not need to be substantially improved—if it meets one of the following tests:
    - Building was vacant in April 2018, was vacant for at least one year immediately before or immediately after, and is still vacant;
    - Building has been vacant for at least three years (for buildings occupied in April 2018); or
    - Building was acquired directly from local government, which must have received title through abandonment, bankruptcy, foreclosure, or some other involuntary transfer (e.g., getting property from a land bank that holds tax titles to properties).

  Each of these tests requires 80% of the property as measured by square feet to be "unused" in order to qualify as vacant.
- *Brownfield Sites*. If a building or a site qualifies as a brownfield under CERCLA (42 U.S.C. 9601), then *any property associated with the site* qualifies as "original use" as long as the owner invests enough to ensure the site "meets basic safety standards for human health and the environment."

Section 3C(2): Substantial Improvement. If property has been previously placed into service in the OZ and does not meet one of the special exceptions above (e.g., vacancy or brownfield), it must be "substantially improved." To "substantially improve" property, the owner must *double its adjusted basis* of the tangible property over *any* 30 month period they select. In performing this calculation, we can *exclude the value of land*—all land-related improvement issues are discussed separately in Section 3C(3) below.

- *Example*. An Opportunity Fund purchases an old warehouse for $5 million, where the warehouse is worth $4 million and the land is worth

$1 million, in June 2020. The Fund plans to spend $4 million on improvements to the warehouse to convert it into workforce housing and retail, starting in March 2021 and continuing through August 2023. This purchase and plan counts as "substantial improvement," meaning 100% of the $9 million spent by the Fund would be "qualified OZ investment."

- *"Substantially Improving" a Business*. If an OZ investor buys an existing business in an OZ (or wants to form a new business with used property it purchased from the OZ), it must double the *overall adjusted basis of the business' tangible property*. For example, if an Opportunity Fund bought an old hotel building for $4 million ($3 million for the building, $1 million for the land), it could spend $2 million on equipment—bedding, linens, kitchen appliances, gym exercise equipment—and $1 million on structural renovations and still qualify. In the same way, an Opportunity Fund could buy an existing OZ manufacturer with $2 million in assets, then buy $2 million more in new assets over *any 30 month period* and have a qualified business.
- *"Substantially Improving" Multiple Properties At Once*. In many cases, a business acquisition or a real estate development plan will involve multiple buildings—sometimes even across multiple parcels. In this case, one of three rules will apply:
  - *Single Deed*: If all the buildings are within the borders of a land parcel described in a single deed, then the owner can aggregate the adjusted basis of all the buildings on the parcel and double that amount without needing to substantially improve each separate structure.
  - *Multiple Deeds, "Single Campus"*: Even with multiple deeds, owners can still aggregate adjusted basis across multiple buildings if the development is part of one "master campus" concept. This means: (i) all parcels are contiguous (as discussed above, separated by something like a street, river, or stream); (ii) all buildings are operated by the same QOZB; (iii) all buildings share common facilities or business elements (e.g., personnel, purchasing, HR, etc.); and (iv) all buildings are operated "in coordination with" the same trade or business.
  - *Multiple Deeds, Multiple Uses:* If multiple buildings spread across multiple parcels are not part of one "single campus" or common business plan (see above), then *each building* needs to be "substantially improved" separately.

Section 3C(3): Treatment for Land. In most cases, land has been "used" in some capacity for hundreds of years; thus, it cannot qualify as "original use" property. However, the IRS decided to provide real estate developers and business owners with considerable flexibility by *totally excluding land from the substantial improvement requirement*.

To prevent abuse (e.g., buying large quantities of land and holding it for appreciation), the IRS requires qualified OZ businesses that purchase land to improve it by “more than an insubstantial amount.” Actions that meet this test include grading, clearing land, remediating contaminated land, or acquiring business property (like farming or planting equipment) that facilitates use of the land in a trade or business. In examples, the IRS notes that simply paving a vacant lot and putting up a parking booth and gates would *not* count as improving land by “more than an insubstantial amount,” but installing an irrigation system and erecting sheds to convert land from a hog farm to a goat farm *would* pass the test.

Section 3C(4): Leased Property. Like raw land, leased property *does not need to be substantially improved*. This means that a qualified OZ business that leases space from a third party or a government entity does not need to improve it at all, making it far easier for startups and other businesses that rely heavily on leased property to qualify.

One other key note about leased property—even though it gets excluded from the “original use / substantial improvement” test (like land), (1) 70% of the leased property needs to be “used in an OZ” (per the discussion in Section 3B above), and (2) the property must be acquired via a lease entered into after December 31, 2017. Unlike Section 3A, however, *leased property can be acquired from a related party* (as described above).

There are a couple of special “leased property” rules designed to prevent abuse:

(1) Leases must be arms length—which typically means that either (i) the lease is between unrelated parties or (ii) there is some kind of objective indicator (third party valuation, appraisal, etc.) showing that the lease is market rate. Any lease between a governmental entity and a qualified OZ business automatically satisfies this standard (even if the lease is only $1 a year).

(2) If leases are between related parties, then (a) they cannot be prepaid for periods longer than 12 months (e.g., they must create real, recurring and ongoing obligations), and (b) the lessee must purchase (within 30 months from lease date) enough property to equal the value of what it is leasing if the property leased is “used” personal property that has already been placed into service in an OZ.

(3) For leased real property, there cannot be a “plan, intent, or expectation” that the qualified OZ business will purchase the property for anything other than fair market value sometime in the future.

Wrap on Sections 3A-3C. There are a few more nuggets on the “Asset Tests” included in the final regulations:

- *Determining Asset Values*. QOZB property can be valued for purposes of the Asset Tests using one of two methods:
    - *Applicable Financial Statement* – if a business has a GAAP-prepared financial statement listing asset values, it can use that statement; or
    - *Alternative Valuation Method* – for businesses without GAAP-prepared financials (or who would prefer not to use them), property values are equal to (i) unadjusted cost basis (for property purchased for fair market value), (ii) reasonable fair market value (for all non-FMV purchases), or (iii) present value of leases (using a formula set forth in Treas. Reg. 1.1400Z2(d)-1(b)(4).
- *Inventory*. Though inventory is typically booked as an asset, its short-term nature could make tracking and compliance with the asset tests quite a headache (especially for manufacturers). As a result, the final regulations permit QOZBs to EITHER (i) totally exclude inventory from the asset tests, or (ii) include inventory, but carve it out entirely while in transit or temporarily warehoused outside an OZ.
- *QOZB Status After a Company Sale*. Once a business passes these tests, it becomes a QOZB, and future acquisitions don't change its qualified status. In other words – if a manufacturer moves into an OZ, qualifies as a QOZB under Tests 3A-3C, then gets sold four years later, the new Opportunity Fund owner does not need to "re-improve" the business.

Section 3D: "Active Conduct" of a Business in an OZ. Under the October 2018 round of regulations, operating companies (from startups to manufacturers) could not qualify as Opportunity Zone businesses unless they could prove that at least 50% of their gross income came from the "active conduct" of their business within an Opportunity Zone. In May, Treasury clarified what that means, and stuck with this explanation in the final round of regulations.

As long as 50% of the services performed by the qualified OZ business are performed in an OZ, it should satisfy the "active conduct" requirement. You can measure whether 50% or more of your services were performed in an OZ by looking at one of three tests:

- *Time Test:* percent of employee / contractor hours spent in *any* zone;
- *Payments Test:* percentage of salary / contractor payments allocable to *any* zone; or
- *"Nexus" Test:* whether the tangible property and management functions of the business in *any* zone generate 50% or more of business revenue. For example, a landscaping business that has its headquarters and key management at an office in an OZ, and that stores all its equipment at its headquarters is a QOZB even though most of its work is done outside the OZ.

Operating just about any business should count as "active conduct," with one critical exception: real estate holding businesses that do nothing but enter into triple net leases. The IRS suggests that the leasing company must "meaningfully participate" in the leased property in some way (e.g., maintenance, paying taxes and insurance, leasing, etc.) in order for the business to be "active" enough to qualify. However, Treasury appears to have some flexibility on this point, providing that a real estate holding company that triple-net leases one floor of a three-story building (while meaningfully participating in management of first two floors) still qualifies as a QOZB.

Section 3E: Intangible Property Used in "Active Conduct." The IRS requires a business to use at least 40% of its intangible property (like IP, patents, goodwill and otherwise) in the active conduct of its trade or business in any OZ. As long as the use of that intangible property (1) is "normal" or "customary" in conducting the business and (2) is leveraged to generate gross income for the business, then it should qualify. What the IRS wants to prevent here are "patent holding companies" and other entities that simply sit on IP they generate (or that third parties generate) and passively profit by allowing others to use the IP.

Section 3F: The "Non-Qualified Financial Property" Requirement. As a general rule, an OZ business cannot—at any time—have more than 5% of its assets in "non-qualified financial property" (NQFP). This includes a wide variety of financial instruments (like debt, stock, partnership interests, futures contracts, options, and other financial products). Businesses can hold cash or cash equivalents in excess of 5% of assets, but only if held in a "reasonable" working capital reserve.

What does a "reasonable" working capital reserve look like? The final regulations provide that *any amount of* cash or cash equivalents held by the business for up to 31 months after funding is "reasonable" if (1) the amounts were designated in writing, (2) the business creates a 31-month spend-down schedule, and (3) the cash gets spent "substantially in accordance" with the 31-month spend-down schedule. If governmental delays interfere with this spend-down schedule, businesses get to "pause the clock" until the delay is cured. Additionally, if a federally declared disaster happens within the subject OZ, a business can have up to 24 additional months to spend down.

For qualified OZ businesses looking to raise and deploy multiple rounds over a 10+ year holding period, the final regulations provide that a non-real estate focused operating company can have multiple 31-month working capital deployment windows, as long as each separately meets the test above. Despite this ability to raise and spend cash, these qualified OZ operating companies can *never* hold more than 5% of their assets in stock or partnership interests of subsidiaries—meaning qualified OZ operating companies will need to be very careful about structuring subsidiaries.

For real estate projects, the final regulations provide that a safe harbor that can be extended for up to 62 months in order to provide time to complete all "phases" of a project—as long as the project gets at least one additional "round" of investment. As with operating companies, each extension beyond the original 31 months must pass all three tests above, *and* the second capital infusion must be contemplated by the original 31-month plan and not a "de minimis" amount.

Section 3G: No "Sin Businesses." A qualified OZ business cannot have more than 5% of its gross income or square feet consist of any of the following activities: private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetrack or other facilities used for gambling, or any "store the principal business of which is the sale of alcoholic beverages for consumption off premises" (like liquor stores but *not* manufacturers or bars dedicated to on-premises consumption). This allows a hotel to have a spa, or a brewery to sell growlers or other direct-to-consumer alcoholic products, as long as those activities remain below the 5% threshold.

Wrapping Up

As described above, the final regulations create some investor-friendly changes to the OZ incentive. Now that these regulations have taken effect, expect even more investment activity in 2020 than we saw in 2019. If you are considering investing or are seeking investment in Alabama, we are happy to help you navigate your next steps - contact us today.

For more information on Opportunity Zones, visit www.OpportunityAlabama.com