How the Final IRS Opportunity Zone Regulations Impact Real Estate Investment and Development in Qualified Opportunity Zones

The final IRS Regulations released December 19, 2019 modify and clarify some of the previously proposed regulations, and retain most of the previously proposed regulations, for real estate investors and developers in Opportunity Zone projects.

The IRS Release of the final Opportunity Zone regulations – consisting of 350 pages of explanations of what was changed and what remained unchanged from the proposed regulations released in October 2018 and May 2019, and almost 200 pages of regulations and examples – contains mostly good news for real estate investors. The regulations provide detailed requirements for investors seeking to qualify for the tax benefits provided from an investment in one of the over 8,700 designated Opportunity Zones, codified as Sections 1400Z-1, and 1400Z-2 of the Internal Revenue Code. This article focuses specifically on those portions of the final regulations that impact real estate investment and development in designated Opportunity Zones.

The final IRS Regulations made the following modifications to the proposed regulations on real estate related investments issued in October 2018 and May 2019:

- **Gross** capital gains from sale of depreciable property and non-depreciable real estate used in a trade or business for more than one year, otherwise known as “1231 assets” in the Code, are now 100% qualified for tax deferral, without the need to net out capital losses;
- Capital gains allocated to investors by a limited partnership or limited liability company can be invested in a qualified opportunity fund (“QOF”) for up to 180 days from the due date of the pass-through entity’s tax return, which further extends the time period for investors to make a qualified investment in a QOF from the proposed regulations that would have started the 180 day period on the last day of the pass-through entity’s taxable year;
- Property that has been **vacant** (defined as more than 80% unused as measured by square footage of usable space) for at least one year before the date the qualified opportunity zone was designated, or for at least three years after the date the qualified opportunity zone was designated, will now qualify as “original use” property, and will not be required to be “substantially improved” to meet the requirements for qualified opportunity zone business property (“QOZBP”);
- All real property that is part of a “brownfield site,” including land and structures, will be treated as satisfying the “original use” requirement to be classified as QOZBP, provided that the land is improved after its acquisition, and the cost of remediation of contaminated land may be included in the calculation of substantial improvements to the property;
- All real property in a designated opportunity zone that is **purchased from a local government** held as a result of abandonment, bankruptcy, foreclosure or receivership, will satisfy the “original use” requirement for classification as QOZBP;
- The 31 month working capital safe harbor for cash held by a QOF may be sequentially applied to each cash contribution on the date received by the QOF, which may extend the working capital safe harbor for a maximum 62-month period;
- **Capital gain realized from the sale of an asset to a QOF**, if reinvested into the same QOF, will not qualify for either the deferral of original capital gain or tax free capital gain at the end of the 10 year holding period – which means that capital gains from sale of an asset to one QOF have to be invested in another QOF if the seller of the asset desires to
defer the capital gains tax on the sale of the asset to a QOF;

- Capital gain that is realized by an investor over time under the installment method can be invested within 180 days from the date of each installment payment, or may optionally be invested for all installment payments that are payable after December 31, 2017, even for installment sales that were entered into prior to December 31, 2017;
- The 31 month working capital safe harbor for cash held by a QOF in connection with a real estate development has been expanded to provide that if a governmental permitting delay has caused the delay and no other action could be taken to improve or complete the project during the permitting process, then the 31-month working capital safe harbor will be tolled for a duration equal to the duration of the permitting delay;
- If a project owned by a QOF that otherwise meets the requirements of the 31-month working capital safe harbor is located in a qualified Opportunity Zone that is or becomes a Federally declared disaster area, the project may receive up to an additional 24 months to utilize its working capital assets if the project is delayed due to that disaster;
- With regard to leases of property between unrelated parties, there will be a rebuttable presumption that the terms of the lease were market rate and therefore satisfy the market-rate lease requirement for treatment of the leased property as qualified opportunity zone business property;
- Clusters of commonly-owned buildings can be aggregated for purposes of applying the substantial improvement requirements; and
- Taxes payable on deferred capital gains, due for the tax year ending December 31, 2026 or upon any earlier disposition of the QOF investment, will be calculated based on the tax rates in effect for the taxable year in which the taxes are payable (not the tax rates for the year in which the deferred capital gains were originally realized).

The final regulations retained the following provisions regarding real estate investments that had previously been proposed:

- Real estate purchased before December 31, 2017 may still achieve the status of QOZBP by leasing the real estate to an affiliated QOF to develop the property, if the following conditions are met:
  - the lease is entered into after 2017;
  - the lease is on market rate terms when it is entered into;
  - the lease does not contain a prepayment of more than 12 months; and
  - there is not a plan, intent or expectation that the QOF would purchase the property for other than fair market value to be determined at the time of purchase.

- A QOF that receives capital contributions in multiple closings may exclude any cash or property contributed to the QOF in exchange for stock or partnership interests for a period of up to six months in calculating its qualified assets. Any cash contributions are required to be held in cash, cash equivalents or debt instruments with a terms of 18 months or less in order to qualify for this six month exclusion.

- A QOF may make distributions to its investors prior to the end of the 10 year required holding period, including distributions of debt financing proceeds, so long as the amount of distributions do not exceed the investors’ tax basis in their QOF interests. The investors’ tax basis does not include the original capital contribution from deferred capital gains, but does include allocations of taxable income of the QOF, allocations of non-recourse debt of the QOF (subject to special rules for debt incurred within two years of the date of investment), and increases in basis after the initial five-year holding period (10% of the original capital contribution) and seven-year holding period (15% of the original capital contribution).

- A QOF may engage in the real estate leasing business, except that that triple net leases are not considered an active
trade or business, which means that the QOF must have some meaningful role in management of rental property to qualify as a QOF.

- A QOF may sell property before the end of the 10-year holding period required for investors to realize tax free capital gains, provided the proceeds are reinvested within 12 months into new qualified opportunity zone property ("QOZP") – although investors will be subject to tax on their allocated share of any capital gain realized by the QOF as a result of the sale.
- Investors in a QOF organized as a limited liability company or limited partnership may receive the benefit of tax free capital gains for inside sales of assets by the QOF after the investors’ 10 year holding period.
- Depreciation recapture on sale of QOZP after the 10 year holding period will not be taxable upon sale of the QOZP by the QOF.

Real estate investors and developers may benefit substantially from the opportunity zone tax incentives, and the IRS has now provided clarity on the means to structure and maintain investments in real estate located in the designated opportunity zones. We anticipate that future legislation will add additional reporting requirements for QOFs to demonstrate their social impact within the opportunity zones, but future legislation is not anticipated to substantially change the requirements for obtaining the tax benefits of investment in these opportunity zones.

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