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## *Treasury Issues Final Qualified Opportunity Zone Regulations*

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On December 19, 2019, the Treasury released final regulations (the “Final Regulations”) that provide guidance on the “qualified opportunity zone,” or “QOZ” tax incentive under Section 1400Z-2 of the Internal Revenue Code (the “Code.”). These Final Regulations follow two tranches of proposed regulations published in October, 2018 and April, 2019 (together, the “Proposed Regulations.”).

To qualify for the incentive, a taxpayer must invest capital gains in a “qualified opportunity fund,” or “QOF” within a 180-day investment period, which generally begins when taxpayer sells or exchanges the asset that generated the gains. Gains timely invested into a QOF will be deferred for tax purposes until the taxpayer sells his or her QOF interest (or upon an “inclusion event”) or December 31, 2026, whichever occurs earlier. In addition, a taxpayer who holds its QOF interest in the QOF for at least five years will eliminate 10% of the deferred gains from taxation, and a taxpayer who holds its QOF interest for at least seven years will increase that gain elimination to 15%. If the taxpayer has not yet sold the investment by December 31, 2026, any deferred gain that hasn’t been eliminated will have to be included in taxable income for that year. If the taxpayer then sells or exchanges its investment in the QOF after holding it for more than 10 years, any appreciation in the interest in the QOF is never taxed.

A QOF must hold at least 90% of its assets in QOZ property, which is defined to include “QOZ business property” or equity interests in an operating subsidiary that qualifies as a “qualified opportunity zone business,” or “QOZB”.

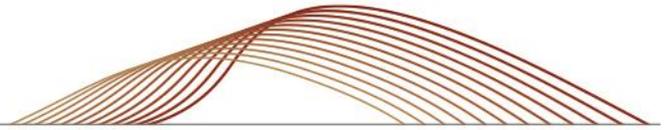
The Treasury explained that the Final Regulations “retain the basic approach and structure of the proposed regulations, with certain revisions.” A few of the highlights of those revisions include the following:

- Adoption of a gross approach to eligible gains arising from Section 1231 property, under which Section 1231 gains will qualify for deferral without regard to Section 1231 losses. This deviates from the Proposed Regulations, under which eligible gains from Section 1231 property were limited to the amount of net gain arising from all of a taxpayer’s Section 1231 property.
- Provision of additional guidance on when the clock on the 180-day investment period starts ticking for (1) certain types of gains including (a) gains from Section 1231 property (on the date of the sale or exchanging giving rise to the gain), (b) RIC and REIT capital gain



dividends (at the close of the shareholder's taxable year in which the shareholder would otherwise recognize that capital gain dividend), (c) gains from installment sales (on either the date a payment under the installment sale is received for that taxable year or the last day of the taxable year the taxpayer would otherwise recognize the eligible gain under the installment method); and (2) certain types of taxpayers, including partners of a partnership, shareholders of an S corporation, and beneficiaries of decedents' estates and non-grantor trusts (for all, the due date of the entity's tax return, not including any extensions).

- Clarification regarding the events that constitute taxable gain inclusion events.
- Confirmation that preexisting entities are not barred from qualifying as QOFs or as qualified opportunity zone businesses, provided that they satisfy the applicable requirements.
- Provision of a safe harbor rule for determining on the two testing dates of a QOF whether an entity is a QOZB for at least 90% of the holding period, in acknowledgment that a QOZB and its QOF parent may have different taxable years.
- Provision of a safe harbor that up to 20% of the tangible property of a QOZB will satisfy the 70% tangible property test if it is used in activities both inside and outside the QOZ.
- Addition of a six-month cure period for an entity in which a QOF has invested to cure a defect that caused it to fail to qualify as a QOZB.
- Further guidance on leasing property, including favorable guidance on leases from state and local governments and Indian tribal governments.
- Adoption of a three-year vacancy requirement for property to satisfy the original use requirement and a one-year vacancy requirement for property that was vacant prior to the designation of the QOZ in which the property is located. This differs from the longer five-year vacancy requirement in the Proposed Regulations.
- Clarification regarding services provided by partners in a QOZB partnership.
- Clarification regarding tolling rules with respect to and overlapping or sequential applications of the 31-month working capital safe harbor, and the creation of a 62-month working capital safe harbor for start-up businesses, which addresses each QOZB requirement, with the exception of the "sin business" prohibition.
- Addition that for QOFs and QOZBs, tangible property purchased, leased, or improved that is undergoing substantial improvements but has not yet been placed in service or used in a trade or business will be treated as used in a trade or business for the 30-month substantial improvement period. This addresses taxpayers' concerns that QOFs are not eligible to utilize the working capital safe harbor set forth in the Proposed Regulations.
- Adoption of an asset aggregation approach to determine when non-original use assets have been substantially improved.
- Determination of where property is "used" for purposes of the tangible and intangible property tests.



- Clarification regarding the application of QOZ rules to consolidated groups.

The Treasury expressly declined to provide additional guidance on the penalty provisions of the QOZ statute, under which a QOF must pay a penalty for each month it fails to meet the 90% asset test. Nevertheless, these Final Regulations are generally taxpayer-friendly and serve to further clarify the application of the QOZ statutes such to allow taxpayers to more confidently move forward with QOF investments.

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*If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings lawyers:*

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