IRS Issues Additional Regulations Providing More Clarity To Opportunity Zone Investments

Description

On Wednesday April 17, 2019, the IRS issued the second round of proposed Treasury Regulations for Qualified Opportunity Zones under the Tax Code (the "New Proposed Regulations"). These regulations provide some much-needed clarity to some of the eligibility requirements for Qualified Opportunity Zone tax benefits.

As a refresher on the potential tax benefits available in Opportunity Zones, investors in a "qualified opportunity fund" (a "QOF") can recognize three potential tax benefits: 1) deferral of eligible capital gains until the earlier of December 31, 2026, or when they dispose of the investment, 2) partial exclusion of up to 15 percent of such deferred capital gains if investments are made by the end of 2019 and held for at least seven years, and 3) exclusion from taxation on any appreciation if the investment is held for at least ten years. The IRS issued the first round of proposed Treasury Regulations back in October 2018, providing some basic guidance and overview of the eligibility rules.

This second round of proposed Treasury Regulations are quite extensive and are generally in addition to, not in replace of, the proposed Treasury Regulations that were issued back in October. These New Proposed Regulations address various issues including:

- providing additional guidance on when certain transactions do and do not create an "inclusion event" (an event that may trigger the inclusion of the previously deferred gain);
- clarifying that operating and leasing real estate can qualify as an "active trade or business", however merely entering into a triple-net-lease with respect to the real property will not qualify as an "active trade or business";
- clarifying the treatment of section 1231 gain and when to calculate how much section 1231 gain is available to roll-over into a QOF;
- providing guidance relating to how vacant land can qualify as an eligible asset for the 90 percent and 70 percent asset tests; and
- adding provisions regarding valuation of leases for purposes of testing whether a QOF or a qualified opportunity zone business (a "QOZB") meets the applicable asset test.

Among the more eagerly awaited guidance are 1) the provisions relating to satisfying the 50 percent gross income requirement for a QOZB and 2) the provisions relating to a QOF's sale of assets. One of the requirements for becoming a qualified opportunity zone business (or partnership) is that at least 50 percent of its gross income is derived from the active conduct of a trade or business in the qualified opportunity zone. The New Proposed Regulations add three safe harbors, and a facts and circumstances test, for determining whether this 50 percent test is met:

1) at least 50 percent of the services performed (based on hours) for the trade or business are performed within the qualified opportunity zone;
2) at least 50 percent of services performed (based on the amount paid for the services) for the trade or business are performed in the qualified opportunity zone; or

3) the necessary tangible property and the management or operational functions of the business are performed in the qualified opportunity zone and are each necessary for the generation of at least 50 percent of the gross income.

Additionally, investors have been eagerly awaiting guidance on what happens when a QOF sells an asset. When a QOF sells an asset there are two immediate concerns: 1) whether the investors recognize gain from the transaction, and 2) whether the cash received from the sale will affect the 90 percent asset test if the QOF holds onto the cash. The New Proposed Regulations provide some relief for recognition of gain from the sale of a QOF asset, but only in a very limited situation. If an investor has held the interests in a QOF treated as a partnership for at least 10 years, if the QOF sells an asset for a gain such investor has the option to elect to treat the gain as an increase in basis instead of recognizing the gain. Otherwise the general taxation rules apply, meaning that if a QOF sells an asset for a gain, the gain is generally recognized for income tax purposes.

The New Regulations do, however, create a safe harbor in the 90 percent asset test for the cash received from the sale of a QOF asset. Ordinarily cash is a “bad” asset for purposes of the 90 percent asset test. The safe harbor generally treats cash received from an asset sale as a “good asset” for purposes of the test if the cash is reinvested in a qualified asset within 12 months. In order to meet the safe harbor, the cash can only be held in certain instruments (cash, cash equivalents or debt instruments with a term of 18 months or less) while waiting to be reinvested during those 12 months.

The New Proposed Regulations can be the impetus for increased investment activities in Opportunity Zones, but there are still many complexities and uncertainties in the regulations. The Treasury Department expects to issue additional regulations in the next couple of months to address, among other issues, the administrative rules relating to a QOF’s failure to maintain the required 90 percent investment standard and information reporting requirements. Prior to creating or investing in a Qualified Opportunity Fund, an investor should become familiar with all of the requirements and any further guidance the IRS may issue as the program becomes more established.

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