Law & Accounting

The Sweet 16 round of opportunity zone proposed regs

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Perhaps Treasury intentionally waited until after March Madness to release the long-awaited second round of proposed regulations on opportunity zones since the proposed regulations presents their own Sweet 16. While Treasury certainly answered critical questions with respect to opportunity zones, below are our 16 takeaways from the proposed regulations. (As with Oscar nominations, we have separated these into categories but present them in no particular order).

As it relates to the tests for qualified opportunity zone business property to be held by the qualified opportunity fund or qualified opportunity fund business, Treasury provided many points of clarification:

1.The original use of the property commences when the property is first placed into service for purposes of depreciation or amortization in the qualified opportunity zone.

2. The original use test can be met if a building has been vacant for at least five years prior to its purchase by an opportunity fund or a qualified opportunity zone business and is placed back into service by such fund or business.

3. Leased tangible property can be good opportunity zone business property if the lease is dated after Dec. 31, 2017.

4. Property leased from related parties can be good opportunity zone business property provided that the lease is on market terms and does not allow for a prepayment of more than 12 months of rent.

5. Unimproved land does not require substantial improvement, but the land must be used in the conduct of a trade or business.

6. A project may straddle opportunity zone and nonopportunity zone real estate if the amount of real estate in the zone is substantial compared to the real estate outside of the zone.

Treasury also provided significant guidance as to qualifying as an opportunity zone business:

7. Merely entering into a triple-net lease of real property does not qualify as the active conduct of a trade or business.

8. The 31-month working capital safe harbor may be extended if there is a delay due to government action or inaction.

9. Three safe harbors for meeting the 50% gross income test were provided – including tests based on the services performed in the zone (based on hours and based on amounts paid) by the business's employees and independent contractors.

Relative to the investment in and testing of the assets of an opportunity fund (and qualified investments therein), the Treasury has provided additional flexibility:

10. Cash invested in the fund within the six months prior to the fund testing date is excluded from the calculation of the 90% test.

11. Cash resulting from the fund's sale of qualified opportunity zone property will be treated as good assets for purposes of the 90% test if the proceeds are reinvested in qualified opportunity zone property within 12 months and the proceeds are continuously held in cash, cash equivalents and short-term debt instruments until properly reinvested. However, the fund and its investors are not shielded from the tax consequences of such a sale unless the 10-year hold period is met at the time the gain would be recognized (see takeaway No. 15).

> **Treasury has continued to widen the lanes for allowable activity to encourage investment in opportunity zones while attempting to maintain the original spirit of the legislation.**

12. Profits/promote interests provided for services rendered to the fund will not be eligible for the opportunity zone tax benefits.

13. A taxpayer can acquire an eligible interest in an opportunity fund by directly purchasing the interest from an existing partner or shareholder in the fund.

There were additional important takeaways that prove beneficial for opportunity zone investments:

14. Debt-financed distributions from the fund (subject to the normal disguised sale rules) are permitted.

15. Investors in funds that are partnerships or real estate investment trusts may exclude their allocable share of capital gain arising from the fund's sale of qualified opportunity zone property if the investor has held its interest in the fund for 10 years, allowing for an easier exit for funds owning multiple properties/assets.

Finally, at 16 on our list: Treasury created a general anti-abuse rule requiring that the opportunity zone rules be applied in a manner consistent with the purpose of the intent of the legislation.

With this latest set of regulations, Treasury has continued to widen the lanes for allowable activity to encourage investment in opportunity zones while attempting to maintain the original spirit of the legislation. Keeping with the original spirit of the legislation of investing in areas that need active economic investment, the rules are designed to make that investment possible. ▲