

## IRS Issues New Opportunity Zone Guidance and Proposed Regulations

Matthew J. Schiller

*Greenbaum, Rowe, Smith & Davis LLP*

**April 18, 2019**

On April 17, 2019, the IRS released highly anticipated additional guidance and proposed regulations concerning investments made under the Opportunity Zone program created under the Tax Cuts and Jobs Act of 2017. The 169-page publication supplements and clarifies many aspects of the initial set of proposed regulations released by the IRS in October 2018 by providing, among other things, significant guidance for investments in qualified opportunity zone businesses (**QOZBs**) and additional clarity as to how to commence, operate and wind down qualified opportunity funds (**QOFs**).

Under the Opportunity Zone program, Congress sought to encourage growth and investment in certain designated low income communities – Opportunity Zones – by providing Federal income tax benefits to qualified taxpayers who invest new capital (i.e., capital gains) into QOFs. This, in turn, helps fund development/redevelopment projects and/or the development of new businesses therein.

The following represents a summary of some key takeaways of the newly proposed regulations:

### **Real Estate Developments**

- **Unimproved Land** – The requirement that the “original use” of tangible property in an Opportunity Zone commence with a QOF will not apply to land, whether improved or not improved. Accordingly, land itself need not be substantially improved; however, the land must be used in connection with the trade or business of the QOF or QOZB.
- **Original Use** – The “original use” of tangible property acquired by purchase by any person will commence on the date that the property is first placed in service in the Opportunity Zone in which depreciation or amortization of such property does or can occur. Accordingly, tangible property in an Opportunity Zone that is previously depreciated or amortized by a taxpayer other than a QOF or QOZB would not satisfy the original use requirement.
- **Vacant Buildings** – A property’s prior use may be disregarded for the purposes of the “original use” requirement if the existing building (purchased after December 31, 2017) has been vacant for 5 years or more.
- **Working Capital Safe Harbor** – QOZBs may extend the 31-month working capital safe harbor if capital deployment delays are attributable to waiting for government action on completed applications that were submitted during the safe harbor period. This clarification is critical for projects located in certain states, such as New Jersey, that can have a lengthy zoning approval process.

Additionally, to help foster the development of new QOZBs in Opportunity Zones, the new regulations expand the working capital safe harbor to apply to QOZB expenditures such as payroll, inventory and occupancy costs during their start-up phases.

- **Improvements to Leased Property** – Improvements made by a lessee to leased property satisfy the “original use” requirement and are considered purchased property for the amount of the unadjusted cost basis of such improvements.
- **Residential Rental Property and Triple Net Leases** – The ownership and operation (including leasing) of real property used in a trade or business can be treated as the active conduct of a trade or business; however, merely entering into a triple net lease will not be considered an active trade or business under the Opportunity Zone program.
- **Straddling Opportunity Zones** – Certain developments may be located only partially within an Opportunity Zone. If the amount of real property based on square footage located within an Opportunity Zone is substantial as compared to the area of contiguous property outside the Opportunity Zone, the contiguous real property located outside of the Opportunity Zone, then all of the real property would be deemed to be located within the Opportunity Zone.

### Leased Property

Under the Opportunity Zone program, QOZBs can own or lease tangible property for the purposes of satisfying the “substantially all” test (i.e., 70% of the QOZBs property must be “qualified opportunity zone business property”). Under the proposed regulations:

- Improvements made by a lessee to leased property satisfy the “original use” requirement and are considered purchased property.
- Leased tangible property can constitute “qualified opportunity zone business property” for the purposes of satisfying the 90% asset test and the 70% “substantially all” tests under the regulations, provided that the leased tangible property: (1) is acquired under a lease entered into after December 31, 2017; and (2) substantially all of the use of the leased tangible property occurs in an Opportunity Zone during substantially all of the period in which the QOZB leases the property.
- Neither the “original use” test nor the “substantial improvement” test is applicable to leased tangible property because a lessee cannot be placed in service for depreciation or amortization purposes as it does not own the property and has no basis therein.
- Tangible personal property can be leased from a “related” party, provided that (1) the lease is a “market rate lease”, (2) the QOF or QOZB does not make any prepayments under the lease that exceeds 12 months, and (3) the proposed regulations do not permit leased tangible personal property to be treated as QOZB property unless the lessee becomes the owner of tangible property that is QOZB property, and that has a value not less than the value of the leased personal property. Certain anti-abuse provisions were also provided to prevent the use of leases to circumvent the requirement to purchase real property (other than unimproved land).

### QOF/QOZB Operations

- **“Substantially All”** – The definition of “substantially all” throughout Section 1400Z-2 was clarified to mean:
  - 70% - For determining the amount of usage of QOZB property (including tangible leased property) within an Opportunity Zone.
  - 90% - For measuring the holding period of tangible property or partnership interest or stock in a QOZB, as qualified Opportunity Zone property.
- **Relief for Newly Contributed Assets** – QOFs may apply the 90% asset test without taking into account investments received within the preceding 6 months.
- **Reinvestment of Interim Gains** – QOFs are given 12 months to reinvest the capital derived from the date of sale of qualified opportunity zone stock, qualified opportunity zone partnership interests or other tangible qualified opportunity zone property.
- **QOF Investments** – Must be in the form of cash or property, not services, in order to achieve the tax benefits provided under the Opportunity Zone program.

### QOZB Gross Income Test

- In order to qualify as a QOZB, at least 50% of the QOZBs total gross income must be “from the active conduct of such business” within an Opportunity Zone. The proposed regulations provide three safe harbors (of which only one needs to be satisfied) as well as a facts-and-circumstances test to determine whether a QOZB satisfies the gross income requirements.
- At least 50% of the services performed (as measured by hours worked) for the QOZB by its employees and independent contractors must occur within the Opportunity Zone.
- At least 50% of the services performed (as measured by the amounts paid for the services performed) for the QOZB by its employees and independent contractors must occur within the Opportunity Zone.
- The tangible property of the QOZB and the management or operational functions performed for the QOZB that are located within an Opportunity Zone are necessary for the QOZB to generate 50% of its gross income.
- Even if none of the aforesaid tests can be satisfied, if based on all facts and circumstances, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business within an Opportunity Zone, the 50% gross income requirement could be satisfied.

### Other Matters

- **Intangible Property** – Under the Opportunity Zone program, a “substantial portion” of the intangible property of a QOZB must be used in the active conduct of a trade or business within an Opportunity Zone, which is defined as “40%” under the proposed regulations.

## Published Articles (Cont.)

- **Inventory in Transit** – Inventory (including raw materials) of a trade or business does not fail to be used in an Opportunity Zone solely based on the fact that it is in transit either (1) from a vendor to the QOZB's facility in an Opportunity Zone or (2) from the QOZB's facility located in an Opportunity Zone to customers outside of the Opportunity Zone.
- **Inclusion Events** – Section 1400Z-2(b)(1) provides that the amount of gain that is deferred if a taxpayer makes an equity investment in a QOF will be included in the taxpayer's income in the taxable year that includes the earlier of (i) the date on which the qualifying investment is sold or exchanged (i.e., an "Inclusion Event") or (ii) December 31, 2026. Certain Inclusion Events are delineated in the newly proposed regulations, including the taxable disposition (i.e., sale) of certain QOF partnership or stock interests and transfers by gift of qualifying investments, and the distribution to a partner of a QOF partnership or property that has a value in excess of the basis of the partner's qualifying QOF partnership interest.

The IRS is now accepting written comments concerning the newly proposed regulations, with a public hearing scheduled for July 9, 2019. We will continue to evaluate the newly proposed regulations and monitor their impact on new developments and new businesses within Opportunity Zones.

If you wish to explore potential opportunity zone opportunities in New Jersey or have questions concerning the content of this Client Alert, please contact the author, **Matthew J. Schiller**.