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Understanding The Treasury Department's Proposed Guidance on Opportunity Zones

On October 19, the Treasury Department released the long-awaited guidance governing the new Opportunity Zone program. Treasury and IRS released the proposed regulations, Revenue Ruling 2018-29, and IRS draft Form 8996. Public comments on the proposed regulations will be accepted for 60 days following publication in the Federal Register.

While the proposed regulations and ruling provide clarity on a number of ambiguities in the law, some important highlights for local and regional governments are the new 70-30 rule, the 31 month safe harbor for working capital, and the definition of 'substantial improvement.'

70-30 Rule

The Tax Cuts and Jobs Act states that a qualified opportunity zone business is a trade or business "in which *substantially all* of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property." The law does not define what is meant by 'substantially all.'

The regulations propose that a threshold of 70 percent would satisfy this definition. So, for instance, if a small fast food chain owned 10 restaurants, only 7 of them would need to be in an opportunity zone for the chain to qualify as an opportunity zone businesses. Or, if a manufacturer held 70 percent of its tangible property in a warehouse located in an opportunity zone, it could keep 30 percent of its tangible property offsite, outside the opportunity zone and still qualify as an opportunity zone business.

The Treasury Department considered applying a 90-10 rule to this definition of 'substantially all,' but decided against it. The more generous 70-30 rule is intended to encourage QOF investment in qualified opportunity zone businesses, rather than direct QOF ownership of qualified opportunity zone businesses.

For example, if a QOF with $10 million in assets invested 100 percent of its assets in real property, it would have to invest $9 million in property in an opportunity zone (90 percent of a QOF's assets must be in an opportunity zone). However, if the QOF invested in a qualified opportunity zone business that held tangible property, only $7 million in property would need to be in the opportunity zone. Further, if the QOF invested only $9 million in the qualified opportunity zone business (satisfying the 90 percent rule), it could invest as little as $6.3 million in the opportunity zone and still be eligible for the opportunity zone program tax benefits.

Given a QOF could invest as little as 63 percent of its assets in an opportunity zone, it is possible the 70-30 rule could lead to a gradual loss of investment dollars to more wealthy areas.

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31 Month Safe Harbor

The Treasury Department received comments asking it to allow cash to be considered QOF property for the purposes of the 90 percent asset test, considering it could take longer than six months to invest in qualifying assets.

In response, the proposed regulations create a capital safe harbor for QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property (including real property and other tangible property used in a business operating in an opportunity zone). The safe harbor allows working capital be held for up to 31 months if certain requirements are met.

This means a qualified opportunity zone business could hold onto cash for a period of 31 months (a little over 2.5 years), so long as 1) there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone; 2) there is a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months; and 3) the business substantially complies with the schedule. Neither the plan or schedule will need to be submitted to the IRS, but they must be made available for an audit if necessary.

The creation of the safe harbor will presumably give QOFs time to develop projects beyond the original 180-day turnaround for reinvestment of capital gains, and will likely benefit real-estate developers given the safe harbor's focus on tangible business property. However, Treasury is seeking comment on expanding safe harbor to the development of business operations in an opportunity zone.

Substantial Improvement Definition

Under the law, QOFs can invest in qualified business property if the original use of the property begins with the QOF or the QOF *substantially improves* the property. Revenue Ruling 2018-29, which was released alongside the proposed regulations, clarifies what exactly is meant by 'substantial improvement' with regard to purchasing existing buildings on land in an opportunity zone.

The ruling outlines that if a QOF purchases an existing building, the building's original use does not begin with the QOF and must therefore be substantially improved by the QOF, but that this requirement does not apply to the land the building is located on. The ruling clarifies that substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building, *excluding the land*. Further, the QOF isn't required to also improve the land the building is on.

The ruling is fairly significant because, by excluding land from the 'substantial improvement' test, it opens up more expensive urban areas to investment. While it could encourage investors to purchase land in an expensive part of town and build affordable housing, it could just as easily

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allow investors to hold onto expensive land while not significantly updating run-down housing or businesses.

What Next?

While the proposed regulations and guidance provide helpful clarity to investors, local governments and other regional stakeholders will need to begin consider how they can best position their communities to receive the full benefits of the opportunity zone program and to protect against any negative consequences.

For a full list of highlights from the proposed regulations please see the following:

Tax Benefits for Investors

- Capital Gains
    - While the law simply refers to 'gains' with regard to the Opportunity Zone program, the guidance clarifies that *only capital gains are eligible for deferral*.
- Taxpayers
    - The guidance clarifies which taxpayers are eligible to defer capital gains under the opportunity zone program. These are:
        - Individuals
        - Corporations (including RICs and REITs)
        - Partnerships
        - Common trust funds under Section 584
        - Qualified Settlement funds
        - Disputed ownership funds
        - Other entities taxable under Section 1.468B
    - The guidance also clarifies the treatment of partnerships and other pass through entities under the law.
        - A partnership may elect to defer all or part of a capital gain. If it chooses to do so, the deferred capital gain is not included in the shares of the partners.
        - If a partnership declines to defer all or part of a capital gain, an individual partner may elect to defer his or her share.
        - The guidance additionally clarifies when the 180-day period of reinvestment with regard to partnerships begins.
- Opportunity Zone Designation Expiration
    - The guidance clarifies that investors who hold their investment in an opportunity zone for at least 10 years are still eligible to increase their basis to the fair market value of the investment on the date it is sold, even after the opportunity zone designation expires. The sale can occur as late as Dec. 31, 2047.

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Qualified Opportunity Funds (QOF)

- Qualified Opportunity Funds can self-certify with the IRS by submitting draft Form 8996 along with Fund's annual income tax return.
- Entities must be considered a corporation or partnership for federal income tax purposes to qualify as a QOF. This means a limited liability corporation could qualify as a QOF under the guidance.
- The law mandates QOFs hold 90 percent of their assets in opportunity zones. The guidance clarifies QOFs should use asset values reported on their applicable financial statement for the taxable year to determine if they meet this requirement. If a QOF doesn't have an applicable financial statement, it should rely on the cost of its assets.
- Only equity investments qualify as legitimate investments in a QOF.
- Under the guidance, preexisting entities can qualify as QOFs as long as they meet the standard requirements.

Qualified Opportunity Zone Businesses

- The law states a qualified opportunity zone business must have 'substantially' all of its tangible property is qualified opportunity zone business property. The guidance clarifies that 'substantially all' means 70 percent.
    - The guidance also clarifies a 'substantial portion' of the intangible property of a qualified opportunity zone business must be used in the active conduct of a trade or business in the qualified opportunity zone.
- The guidance clarifies opportunity zone businesses can hold working capital for up to 31 months if they meet certain requirements.
- At least 50 percent of the gross income of a qualified opportunity zone business must be derived from the active conduct of a trade or business in the qualified opportunity zone, under the guidance.
- As with QOFs, preexisting entities can qualify as opportunity zone businesses as long as they meet the standard requirements according to the guidance.

Outstanding Issues

A number of outstanding ambiguities in the law remain, and Treasury plans to release additional opportunity zone guidance before the end of the year. Possible issues that could be addressed include:

- How QOFs will be treated if they sell an investment in an opportunity zone and reinvest the gains in another opportunity zone asset.
- How a qualified opportunity zone business meets the 'active' trade or business requirement.
- Whether QOFs will also be given 31 months to hold onto working capital.
- The meaning of 'substantially all' in other instances in the law.

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Resources:

Opportunity Zones Frequently Asked Questions. IRS

Opportunity Zones Fact Sheet. Summit Strategies

Opportunity Zones Page. Economic Innovation Group