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RBJ BUSINESS JOURNAL
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MARCH 9, 2020

IRS issues final regulations on opportunity zones

The U.S. Department of Treasury has now finalized its rules on the Opportunity Zone program, which provides incentives for investments in low-income communities.

The long-awaited final regulations were over a year in the making. They provide clarity on many issues that had previously been vexing opportunity zone investors.

This article reviews the final regulations with a focus on implications for real estate investors.

By way of background, Opportunity Zones were created as part of the 2017 Tax Cuts and Jobs Act. Opportunity Zones are communities designated by the states as low-income and undercapitalized. Opportunity Zone incentives were created to spur private investment and large-scale economic development in such communities. There are more than 120 Opportunity Zones in the Western New York region.

Taxpayers that invest in Opportunity Zones can defer, reduce, or even eliminate their federal capital gains tax liability.

To invest, a taxpayer must first create a structure known as a Qualified Opportunity Fund (QOF). The QOF may, in turn, own real estate or other property in the opportunity zone, or own an interest in a business in the opportunity zone.

When a taxpayer sells an existing asset with capital gain, the taxpayer must reinvest the gain within 180 days into the QOF. After the interest is held in the QOF for five years, the taxpayer can exclude 10 percent of the deferred gain. (The opportunity to defer an additional 5 percent of the gain existed in 2019.)

On Dec. 31, 2026, however, the deferral period terminates. This means that the taxpayer recognizes the deferred gain that remains. This so-called "phantom gain" is considered the biggest drawback of the Opportunity Zone program.

Finally, after 10 years, the taxpayer can sell its QOF investment and exclude the entire gain resulting from the sale. This exclusion is an exciting opportunity for investors, though it may have a more modest impact than anticipated locally due to the low rate of appreciation on real estate assets.

The final regulations are the culmination of two draft rounds of regulations which often raised more questions than they answered.

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The new regulations, however, provide much needed clarity about a variety of topics, including the following:

Building Improvements. Under the proposed regulations, real property needs to be substantially improved in order for it to qualify for opportunity zone benefits. This means that the investor put an amount equal to the value of any existing buildings into renovating them.

Under the proposed regulations, compliance with this so-called substantial improvement test was measured on an asset-by-asset basis. For example, if an investor purchased a portfolio of ten properties, it was required to substantially improve each of them. The final regulations provide some additional flexibility. If buildings are located on a single parcel or contiguous parcels, it is generally possible to measure improvements on an aggregate basis. Certain ancillary purchases can also be counted as improvements, such as purchases of furniture.

Vacant Property. Vacant property is exempted from the substantial improvement requirement. The proposed regulations defined vacant property as property which has been vacant for five years. The final regulations relax this rule to property that has been vacant at least one year, or, in some circumstances, three years. Vacancy is also liberally defined, to allow for a small portion of the property to be occupied and still count as vacant.

Triple Net Leases. Properties leased out under triple net leases do not qualify for opportunity zone benefits. However, an example in the regulations illustrates that it is acceptable if a portion of a property is subject to a triple net lease. However, the example doesn't clarify the outer boundaries of the extent of triple net leases that are permitted.

Certain Real Estate Gains. Many investors in real estate commonly recognize a certain special type of gain known as 1231 gains that they may wish to invest in opportunity funds. The Proposed Regulations were less favorable to taxpayers recognizing these gains in that they required taxpayers to wait until year-end to calculate them, and offset gains by any related losses, before they were able to invest in an opportunity fund. Now, under the final regulations, a taxpayer can immediately contribute such gain to a QOF, thus allowing for an investment of gross gains, and avoiding the waiting period.

Working Capital Safe Harbor. Under the Proposed Regulations, investors had a 31-month safe harbor to deploy funds placed in opportunity zone vehicles, as long as technical requirements were met. The final regulations do investors a favor by extending that safe harbor to a longer 62-month period in some circumstances. To qualify, a business must have planned to and in fact received an additional cash infusion during each 31-month safe harbor period.

Anti-Abuse Rules. The final regulations add broad new anti-abuse rules. For example, they provide that an investor cannot sell an asset to an opportunity fund and invest the same gain realized into the fund. Some things are too good to be true.

The final regulations and preamble span 544 pages, so this summary is necessarily highly selective. I have focused on a few key areas related to real estate, as much of the interest we have seen locally is real estate related. Every opportunity zone investor will find material related to their personal area of interest in the final regulations.

Complexity aside, the tax incentives provided by opportunity zones can make investing in the designated census tracks worthwhile for many investors. In addition, QOF investments can greatly benefit local communities and economies by providing housing, jobs, and other benefits. Interests in QOFs can be held until the end of 2047, providing potential tax benefits for many years to come. However, the final rules are highly technical and contain many traps for the unwary. Careful planning and tax guidance are essential to ensure all potential benefits are received.

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