Rochester Business Journal
RBJ
VOLUME 35, NUMBER 8 WWW.RBJ.NET MAY 24, 2019

New opportunity zone regulations from IRS introduce flexibility

The IRS has released highly anticipated regulations on the opportunity zones program, a new tax incentive program for investment in low-income communities.

The taxpayer-favorable regulations clarify many key issues that had not been explained in prior guidance, both for real estate investments and investments in operating business. This article, which supplements and replaces my prior article on this topic, reviews these key changes.

First, some background:

Congress enacted the opportunity zone program as part of the 2017 Tax Cuts and Jobs Act to provide incentives for investment in low income communities. To take advantage of the opportunity zone rules, investors must first sell an existing property with capital gain. Gains from that property must then be invested in one of the over 8,700 designated census tracts around the nation, including more than 120 in Western New York.

Investors receive two classes of benefits: tax deferral and gain elimination.

First, all of the gain on the sale of the original investment is deferred until the end of the 2026 tax year. This deferral benefit is similar to the benefit received by participants in "like kind exchanges" of real estate, but is available for all types of purchases and sales.

However, the party ends in 2026 when the deferral period terminates. The phantom gain in 2026 is the single biggest drawback of the opportunity zones program, though its impact can be mitigated, for example if cash can be borrowed against the investment to pay the tax.

Second, taxpayers are eligible for gain elimination, both on the original investment, and the replacement investment.

If the replacement investment is held for five years, 10% of the gain from the sale is eliminated. If the replacement investment is held for 15 years, an additional 5% of the gain is eliminated. Because of the 2026 deadline above, investments must be made this year for the full 15% gain elimination benefit to be achieved.

In addition, gain elimination is available

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Josh Gewolb

on the sale of the replacement investment. If this investment is held for 10 years, 100% of the gain on its eventual sale is eliminated. This is perhaps the most exciting benefit under the new law, though for many local real estate investments, given the low rate of appreciation as well as the time value of money, it actually may have a somewhat modest impact.

Since the enactment of the opportunity zone program, there have been many uncertainties about its operation. The 2018 regulations provided helpful guidance, but left many questions unanswered. The recent regulations address a number of these questions.

Most of the activity to date related to opportunity zones has focused on real estate. In the real estate area, the new regulations are helpful—and taxpayer friendly. Taxpayers are required to "substantially improve" real estate investments making improvements equal to the value of the existing buildings (but not the underlying land). These are measured on an asset-by-asset basis.

Commentators had asked how vacant land was treated under these rules. The new regulations clarify that investment in vacant land can qualify for opportunity zone benefits. Subject to anti-abuse rules, the land does not need to be substantially improved. Intriguingly, if a building has been abandoned for more than 5 years, it also does not need to be substantially improved.

Improvements made to leased property also qualify for opportunity zone benefits, so long as the lease was entered into in 2018 or thereafter, and technical rules are met. There is no substantial improvement requirement.

As noted above, borrowing money against real estate investments and making a distribution is a way to cover the tax liabilities due in 2026. The new regulations confirm that this strategy is permitted for investments through LLCs.

Investors have 31-month safe harbor to deploy funds placed in opportunity zones vehicles, as long as technical requirements are met. The new regulations helpfully provide that this period may be extended in the case of delays in governmental approvals.

In addition to the guidance related to real estate projects, the new regulations contain much anticipated guidance related to operating businesses.

A number of special technical rules apply to operating businesses. One rule that had drawn attention required that least 50% of the gross income of this business be in an opportunity zone. This led commentators to question whether a business that makes sales outside an opportunity zone can qualify.

The new rules provide flexibility in this regard. The 50% test can be met based on where employees and contractors are located, where property is located/where managerial functions are performed, and by an alternate facts and circumstances test.

When the prior regulations were proposed last year, I advised clients that the risks and uncertainties were so great, that I would hold off on making opportunity zone investments. While I would still wait for final regulations before closing a deal, there is now enough guidance to thoughtfully evaluate a potential investment and review whether the opportunity zone program is a good fit.

The tax benefits of the program are very powerful, but the program is also really quirky, particularly in regard to the deemed gain recognition in 2026. For the right taxpayer, and the right investment, this is an unprecedented opportunity. The new regulations provide key information that investors can use in determining whether the program makes sense for their project.

Josh Gewolb is a tax partner at Harter Secrest & Emery LLP.