How Do Opportunity Zone Deals Really Work?

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Client Alert

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Expectations are high this year for “Opportunity Zones” in the real estate industry. A product of the Tax Cuts and Jobs Act, Qualified Opportunity Zones (QOZs) are expected to be one of the biggest trends to impact real estate in 2019, but many developers are still trying to figure out how to take advantage of the tax benefits promised.

Qualified Opportunity Funds (QOF) represent an opportunity for investors in those areas that have been designated as QOZs. More than 8,700 U.S. Census tracts have been designated as QOZs across all 50 states, Washington, D.C., and some U.S. territories. On Oct. 4, the Department of the Treasury and the Internal Revenue Service issued the first of several anticipated proposed regulations concerning QOZs.

To summarize, a real estate investor, fund manager or other Opportunity Zone investor can realize tax benefits in two ways.

- First, a taxpayer may defer the inclusion in gross income of capital gains to the extent that corresponding amounts are timely reinvested in a QOF. The gain is deferred until the date the QOF is sold or exchanged or Dec. 31, 2026, whichever is earliest. If the QOF investment is held for longer than 5 years, there is a 10 percent exclusion of the deferred gain. If held more than 7 years, it becomes 15 percent.

- Second, if the investor holds the investment in the QOF for at least 10 years, the investor is eligible for an increase in basis of the QOF investment to its fair market value on the date the QOF investment is sold or exchanged.

A taxpayer that already owns real property in a QOZ may still be able to participate in the tax benefits by selling its property to a QOF (or QOF subsidiary) in which the taxpayer owns an interest of 20 percent or less or ground leasing its property to a QOF (or QOF subsidiary) provided certain other rules are met.

The proposed regulations leave some important questions unanswered. For example, the proposed regulations clarify that gains can be transferred from Opportunity Fund to Opportunity Fund until 2026, when the deferred and reduced capital gains tax must be paid. However, the proposed regulations do not address whether (or how) sequential transfers will be eligible for an increase in basis upon the final sale or exchange. More regulations on fund-to-fund transfers and other subjects are still to come.

However, the proposed regulations do answer many of the most pressing questions with generally taxpayer-friendly answers and give businesses enough flexibility and certainty to start making major investments. For example:

- Included in the proposed regulations are rules permitting a corporation or partnership to self-certify as a QOF.

- The proposed regulations create a 70-30 rule that measures whether a given business counts as having “substantially all” of its assets in an Opportunity Zone. Under that rule, as long as 70 percent of a business’s tangible property is in a zone, the business doesn’t lose its ability to qualify for the tax benefits.

- The proposed rules create a working capital safe harbor giving businesses an additional 30 months to hold working capital, as long as they have a plan for a qualifying project in a zone.

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For more information on all of the proposed regulations, please click **here** for analysis from Brownstein's national Tax Group.

We will continue to monitor additional guidance from the Department of the Treasury and the Internal Revenue Service. Brownstein's national Tax Group can assist you in assessing the impact these rules will have on your business, next steps to consider and whether to submit written comments to the proposed guidance.

Our team has significant experience with the rulemaking process. To the extent questions are unanswered or the rules are not clear, our team can facilitate a dialogue with policymakers to help resolve your issues.

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