LEGISLATIVE UPDATE

QUALIFIED OPPORTUNITY ZONES: NEW RULES PAVE THE WAY FOR INCREASED PARTICIPATION

By Erin Stackley

On April 17, 2019, the Treasury Department released the second round of proposed rules for the Qualified Opportunity Zone ("QOZ") program. This proposal would build upon the earlier released rules that provided the framework for the program. These rules were originally predicted to be out in January, and the delay in their release contributed to the hesitancy of some investors to utilize the program without knowing exactly how many aspects of it will work. Now, with more details on the specifics of the program, investments into the designated Zones are expected to begin in earnest.

This second round of rules fills in many unknowns about the QOZ program and how it will work. To summarize the program broadly, it is a creation of the Tax Cuts and Jobs Act of 2017, intended to drive new investment, jobs, and development to underserved communities designated as "Opportunity Zones." It provides several types of tax relief for investors who reinvest capital gains into QOZs:

- Deferral of paying tax on capital gains reinvested within 180 days into an "Opportunity Fund," ("O Fund") until the earlier of December 31, 2026, or the date the interest in the O Fund is sold;
- If reinvested gains are held in an O Fund for at least five years, there is a 10 percent reduction in the capital gains tax due; if held for seven years, that increases to 15 percent;
- Appreciation on reinvested capital gains held in an O Fund for at least ten years is tax-exempt.

The new rules provide clarity on questions about the program left unanswered by the earlier rules. For example, tangible property purchased by an O Fund in a QOZ must be either "original use" or "substantially improved"—but "original use" was left undefined. We now know that "original use" commences with the depreciation of an asset; positive news for real estate, as it allows O Funds to purchase incomplete projects in QOZs and meet the "original use" requirement as long as the property has not been depreciated yet. The issue of vacant or abandoned property is also addressed—if it has been in that condition for at least five years, the original use commences with the purchase by the O Fund. If it has been that way less than five years, it must meet the substantial improvement requirement: investing an equal amount into the asset as its purchase price, not including the basis of the land it sits on.

The QOZ Business Property information is also fleshed out. We know that it must be used in the active conduct of a trade or business (so simply investing in land does not qualify). The rules also inform us that leased tangible property qualifies as long as the lease was entered into after 2017 and meets the same requirements as owned property. Additionally, there is guidance for property straddling a QOZ—if it is contiguous, and the value of the portion within the QOZ is greater than that outside of it, all of the property is considered QOZ business property.

There are still questions about the QOZ program that the Administration will need to address. One area is data reporting requirements, which are important both to protect against fraud and abuse in the program and to track its effectiveness—what types of investments and developments are successful versus not, and where the program is working best. Both the Department of Housing and Urban Development and the Treasury are seeking input on what those requirements should be.

The Administration is on track to have final rules by the end of 2019, barring any delays. Until then, the proposed rules are effective, and with the new information from the second round, we expect to see participation in the program increase rapidly in the coming months.