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New Opportunity Zone Regulation Provides Further Planning Opportunities

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Taxpayers who invest eligible capital gains into qualified opportunity funds can potentially take advantage of significant federal income tax benefits. Among these benefits are the potential deferral of such capital gains until Dec. 31, 2026 and the potential to avoid income tax completely on any gains accrued on the investment in the qualified opportunity fund if the investment is held for at least 10 years. However, in order to qualify as a qualified opportunity fund, an entity's assets must generally have been acquired by purchase after 2017. Thus, without further structuring, a taxpayer who owns property in a qualified opportunity zone that it purchased before 2018 would be unable to benefit from these rules.

However, in 2019, the Treasury Department finalized regulations that allow qualified opportunity funds to acquire leasehold interests in properties that were purchased prior to 2018 if the lease is on market terms, even if the fee interest in the property is owned by a related party. This is generally the case regardless of the extent to which the lessee improves the leased property. (However, if a taxpayer leases property to a qualified opportunity fund and then the fund makes only limited improvements to the property, the transaction may fall under an anti-abuse rule, which allows the IRS to recharacterize transactions that do not fall within the purposes of the qualified opportunity fund rules, which is to encourage the making of new investments in qualified opportunity zones.)

Therefore, a taxpayer who intends to develop property located in a qualified opportunity zone that it purchased prior to 2018 can often lease the property to a qualified opportunity fund, and the leasehold interest may then qualify for qualified opportunity zone benefits. However, the fee position in the property would not qualify for such benefits.

In 2021, the Treasury Department made changes to the regulations that open up yet another possibility for taxpayers who acquired property located in qualified opportunity zones prior to 2018 to take advantage of these rules. Generally, if a qualified opportunity fund owns an interest in a lower-tier entity (referred to as a "qualified opportunity zone business"), then, among other requirements, at least 70% of the lower-tier entity's tangible assets must be qualifying property (i.e., property that was purchased or constructed by the entity after 2017).

For this purpose, there is a safe harbor that suspends certain qualified opportunity zone business requirements during the period that the entity's working capital is being invested, so long as that investment is made pursuant to a written plan to develop a trade or business in a qualified opportunity zone and is spent within 31 months. (Qualified opportunity zone businesses are permitted to have multiple overlapping 31-month safe harbor periods with respect to separate injections of capital, but may not utilize the safe harbor for more than 62 months in total.)

The newly issued regulations make clear that along with certain other requirements, the 70% test is suspended entirely during the period in which this safe harbor applies. Although this rule only applies to "start-up businesses," new real estate development should be considered a start-up business for this purpose.

This new rule is important because it allows a structure whereby a taxpayer seeking to develop land in a qualified opportunity zone that it acquired prior to 2018 can contribute the land to a qualified opportunity zone business. Even though the land itself will not be a qualifying asset, the taxpayer likely would not have to worry about the 70% test until the end of the safe harbor period, after which the value of the building or other improvements constructed on the property would likely constitute more than 70% of the value of the qualified opportunity zone business.

One important technical point worth considering is that if land is contributed to a qualified opportunity zone business, the regulations generally require the land to be valued at fair market value for purposes of the 70% test, determined every six months.

By contrast, the building or other improvements constructed by the qualified opportunity zone business would be valued at their cost basis, and are not adjusted by future increases in value.

Thus, if the value of the land increases over time, under a technical reading of the rules, it is possible that the entity may eventually fail the 70% test at some future date, resulting in disqualification as a qualified opportunity zone business at that time, although this result makes little sense. This valuation issue does not apply if the taxpayer has GAAP financial statements and instead uses GAAP to determine its qualification under the 70% test.

In sum, the 2021 regulations provide a significant benefit to taxpayers who purchased property in qualified opportunity zones prior to 2018, because they provide a mechanism for such taxpayers to develop the property and obtain the associated income tax benefits without the need to use a lease structure. However, there are several pitfalls that must be avoided, including the valuation issue discussed above.

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