

ATTORNEYS DISSECT TREASURY GUIDANCE

BY JOHN W. GAHAN III AND DANIEL P. RYAN

Treasury issued its long-awaited guidance on Opportunity Zones (OZs) in October. Not all questions were answered; Treasury itself acknowledged that and promised further guidance. That said, it's useful now, especially for developers with projects in OZs who would like to access capital in Qualified Opportunity Funds (QOFs), to summarize a few important takeaways:

1. Debt is not itself an acceptable qualifying investment in a QOF, and using debt doesn't reduce the capital gain investor's ultimate tax benefit.

Under existing tax principles, an increase in a partner's share of partnership debt is treated as a "deemed contribution" of money to the partnership by the partner, under rules found in Code Sec. 752(a). If such "deemed contribution" applied to a partnership that purchased Qualified Opportunity Zone Property (QOZP) using debt, it might reduce the taxpayer gain appreciation benefit. Treasury's proposed regulations eliminate that worrisome result.

2. For purposes of the "tangible asset" test, the term "substantially all" means 70%.

The legislation requires that, at all times during a QOF's holding period, substantially all of the tangible assets of the trade or business be qualified property purchased after Dec. 31, 2017.

The proposed regulations establish 70% as the percentage of tangible assets that the trade or business must own or lease to satisfy the "substantially all" benchmark.

3. A "working-capital safe harbor" aligns the OZ legislation with the mechanics of how capital usually flows into development projects.

The proposed regulations, at the Qualified Opportunity Zone Business (QOZB) level, authorize a working-capital safe harbor whereby money in a QOF could be advanced into the entity owning/operating the QOZB over a 31-month period pursuant to a written schedule for the payment of expenses. There are some minimal requirements relating to the written schedule and when the working capital must be spent, but the principle advanced is what the industry wanted.

4. Rev. Rul. 2018-29 provides that the land and building costs of purchase can be separated for purposes of the "substantial improvement" test.

Values can be attributed to both, and then the "substantial improvement" test can be satisfied by improving the building by the required amount.

5. Pre-existing entities can be used but are subject to important preconditions.

What Comes Next?

The industry still awaits answers to many questions, including:

1. Can investor entities use "feeder funds," which aggregate large amounts of capital and then deploy the capital into separate QOFs?

2. Will there be more-liberal exit rules for individual investors who currently must sell their interest in the QOF to realize the tax benefit of the exclusion of gain?

3. Will QOFs be able to sell assets and reinvest the proceeds in another QOF with continuing tax benefits and with flexible holding period rules?

4. Will Treasury delineate the consequences of noncompliance?

One Final Thought

When the industry first parsed the legislation, many feared there would be a host of bureaucratic rules with penalties, and so on. Thankfully, in the main, Treasury has opted to be "permissive" rather than "restrictive." Developers should take comfort that if they stay within the minimal guardrails, Treasury won't look to play "gotcha."



John W. Gahan III and Daniel P. Ryan are partners and members of the OZ practice group at the Sullivan & Worcester law firm in Boston.