Update on Real Estate Investing and Qualified Opportunity Zones

On April 17, 2019, the Department of Treasury and the IRS released a second set of proposed regulations on Qualified Opportunity Zone investments (the "Proposed Regulations"). The Proposed Regulations address many of the questions and issues surrounding the Qualified Opportunity Zone program, in some cases supplementing and clarifying a first set of proposed regulations that were issued on October 29, 2018.

This alert highlights a few of the key provisions of the Proposed Regulations relevant to real estate investments in Qualified Opportunity Zones.

Property Partially Within and Partially Outside Qualified Opportunity Zones

The Proposed Regulations provide that if a qualified opportunity fund ("QOF") or qualified opportunity zone business ("QOZ Business") holds and uses a contiguous parcel of land, part of which is within and part of which is outside of an opportunity zone, the entire parcel of land is deemed to be within an opportunity zone if the square footage of the property within the zone is "substantial" in relation to the square footage of the property outside the opportunity zone. The preamble to the Proposed Regulations states that real property should be treated as "substantial" if the unadjusted cost of the real property inside the opportunity zone is greater than the unadjusted cost of real property outside the opportunity zone.

Clarification of the "Original Use" Test

For property to qualify as qualified opportunity zone business property, the property's "original use" in the opportunity zone generally must be commenced by the QOF or QOZ Business. If the original use in the opportunity zone is not commenced by the QOF or QOZ Business, then such QOF or QOZ Business must "substantially improve" the property.

The Proposed Regulations clarify that the commencement of the original use of property acquired by purchase by any person is the date when the property is first placed in service in the opportunity zone. The Proposed Regulations further clarify that used tangible property can satisfy the "original use" test if the property has not been previously used (i.e., placed in service) by any taxpayer in the qualified opportunity zone.

In addition, the Proposed Regulations provide that vacant buildings or other structures located within a qualified opportunity zone which had previously been placed in service by any taxpayer may satisfy the "original use" test if the building or other structure has been vacant for at least five years prior to being purchased by a QOF or QOZ Business. This provision in the Proposed Regulations relating to buildings or other structures located within a qualified opportunity zone permits certain vacant buildings to qualify as qualified opportunity zone property even in circumstances in which the QOF or QOZ Business does not otherwise need to make significant improvements to the building or property to make use of the building or property.

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Treatment of Leased Property

The Proposed Regulations clarify that leased tangible property can qualify as “qualified opportunity zone business property”, subject to certain anti-abuse rules, provided that:

- The leased tangible property must have been acquired under a lease entered into after December 31, 2017; and
- The lease terms must be “market rate” (i.e., the terms of the lease reflect common, arms-length practice for the location of the property) at the time the lease is entered into.

The original use of such leased tangible property does not need to commence with the QOF or QOZ Business, and the leased tangible property does not need to be substantially improved.

The Proposed Regulations also clarify that property leased from related persons can qualify if the following additional tests are satisfied:

- The lessee cannot make prepayments on the lease by more than 12 months; and
- If the original use of the leased tangible personal property in an opportunity zone does not commence with the qualified opportunity fund or business, the qualified opportunity fund or business must purchase other tangible property that is qualified opportunity zone property at least equal in value to the leased tangible personal property.

31-Month Working Capital Safe Harbor

The proposed regulations released in October 2018 included a safe-harbor rule permitting a QOZ Business to hold working capital for up to 31 months under certain circumstances. The Proposed Regulations include two important clarifications:

- First, the safe harbor was expanded to include working capital designated for the development of a trade or business in an opportunity zone as well as acquisition, construction, and the substantial improvement of tangible property.
- Second, the safe harbor period may be extended past the 31-month period if the delay in expending working capital is due to waiting for government action, provided the application for such government action is completed during the 31-month period.

This second clarification is especially important for real estate investments and development projects in opportunity zones, which may require zoning approval or construction/development approval from state or local governments.

Substantial Improvement Test Among Multiple Assets

Under the Proposed Regulations, the determination of whether property is “substantially improved” is on an asset-by-asset basis for purposes of qualifying as qualified opportunity zone business property. The Treasury and the IRS acknowledged that requiring the determination to be made on an asset-by-asset basis may be onerous for certain businesses and have requested further comments on the potential advantages and disadvantages of adopting an aggregate approach.

The asset-by-asset approach may become a trap for unwary businesses (particularly operating businesses) acquiring multiple properties for development on different timelines.

Clarification of "Substantially All"

The Proposed Regulations clarify that the term "substantially all" with respect to a QOF's holding period of property or corporate stock/partnership interests in a QOZ Business means 90 percent of such QOF's holding period. The Proposed Regulations also reiterate that the term "substantially all" means a threshold of 70 percent for purposes of whether property owned or leased was used within an opportunity zone.

The Proposed Regulations address needed clarification on the compounded use of the term "substantially all" under Section 1400Z-2(d)(2) of the Internal Revenue Code (establishing the conditions for property to be treated as qualified opportunity zone business property, Section 1400Z-2(d)(2) requires "during *substantially all* of the qualified opportunity fund's holding period for such property, *substantially all* of the use of such property was in an opportunity zone").

In addition to these provisions, other portions of the Proposed Regulations, including those relating to investment timing, gains from sales by a QOF and reinvestment rules, provide significant clarification and flexibility for developers, real estate investors and business owners, and early reaction to the new guidance has been very positive.

FOR MORE INFORMATION

If you have questions about the subject matter of this Choate Alert, please contact one of the following members of the Real Estate Group:

Paul C. Laudano
617-248-4745 | plaudano@choate.com

Adam M. Zaiger
617-248-4091 | azaiger@choate.com

Timothy J. Becker
617-248-5141 | tbecker@choate.com

John Marshall Chambers
617-248-5212 | jchambers@choate.com

Gregg B. Cosimi
617-248-4003 | gcosimi@choate.com

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