Highlights of New Opportunity Zone Regulations

PE LAW // Additional guidance provided by the Treasury Department

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In April, the Department of the Treasury released the second round of regulations related to the opportunity zone program. Some highlights include:

More flexible exits and "churning." Taxpayers who invest in a qualified opportunity fund (QOF) that is a partnership or S corporation (a tax "flow-through" entity) and who have held their interest for at least 10 years may elect to exclude from income the capital gain from the disposition of qualified opportunity zone property that flows through to the fund's investors. This election should facilitate the use of multi-asset QOFs by allowing the fund to dispose of certain assets directly, after investors have held their interest for more than 10 years. It should also allow QOF investors to recognize the 10-year appreciation exclusion without having to sell their interest in the fund.

If a flow-through QOF disposes of qualified opportunity zone property before investors have held their interest for 10 years, income would flow through to the investors and be subject to tax under normal flow-through tax rules. This income would not impact the holding period or deferral on qualifying investments in the QOF, allowing for the disposition of unsuccessful investments (no gain) with potentially no negative investor-level impact. Further, disposition proceeds will not be treated as "bad" assets for QOF qualification testing if they are retained as cash or certain cash equivalents and reinvested within 12 months.

Working capital safe harbor. The working capital safe harbor was expanded to include funds designated in writing for the development of a trade or business in an opportunity zone. The new regulations clarified that government delays—such as zoning approval—will not cause a failure to meet the 31-month time period to deploy funds under the safe harbor. An example in the regulation also suggests the written plan or budget doesn't need to identify the specific assets the business will acquire. Importantly, the safe harbor is only available at the underlying Qualifying Opportunity Zone Business level and not within the fund itself.

Interests for services. Prior regulations left open the possibility that those who invested capital and also received an interest in exchange for services could have a qualifying investment with respect to their entire interest in the QOF. The new regulations clarify that if a taxpayer receives an interest for services rendered to the QOF, QOF tax benefits are not available for that interest.

Triggering events. The new regulations address transactions that may trigger the inclusion of gain that a taxpayer has elected to defer upon an investment in a QOF. These rules include a clarification that a distribution on a partnership interest will not be considered an inclusion event if it is not in excess of the partner's basis (including its share of the QOF's liabilities). However, the new regulations suggest that debt-financed distributions made within two years of the initial investment may be treated as a disguised sale of the partnership interest and, thus, may be treated as disposition of a portion of the investors' interests in the QOF.

Active trade or business. The proposed regulations clarify that the ownership and operation (including leasing other than a triple-net lease) of real property is the active conduct of a trade or business. //

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