

## IRS Issues New Guidance for Opportunity Zones: What Investors and Businesses Need to do to Benefit from New Tax Incentives

04.19.2019

On Wednesday, April 17, the IRS issued the highly anticipated, second round of proposed regulations on the Opportunity Zone ("OZ") Program, which was established by Congress in 2017 to spur investment in distressed economic areas. The program provides investors with the ability to defer and reduce tax on capital gains that are reinvested in a Qualified Opportunity Fund ("QO Fund") if certain conditions are met. A QO Fund is an entity that invests in qualified property located in an OZ or equity in qualified businesses located in an OZ.

The OZ legislation raised numerous complexities and uncertainties that the IRS was tasked to clarify. The initial round of proposed regulations, issued in October of 2018, provided some guidance (mainly in the area of real estate investments), but left many questions unanswered. The new regulations answer many, but not all, of those questions. We will address the most significant developments in a multi-part series. This first part focuses on operating businesses.

### 50% Gross Income Test

For an equity investment in an operating business to qualify, the business must satisfy several statutory requirements, including a requirement that it generate at least 50% of its gross income from within an OZ (the "income test").

Most operating businesses generate income by selling products or services to customers located in a wide area. Potential OZ investors have been concerned that even if a business is headquartered within an OZ, the income test may not be satisfied if the business's sales are to customers not physically located in the OZ. This uncertainty has had a chilling effect on OZ investments into operating businesses.

To address these concerns, the new regulations provide three safe harbors for an operating business to satisfy the income test:

- 50% of the total hours of services performed for the business by its employees and independent contractors during the year are performed in the OZ.
- 50% of the total amounts paid by the business for services during the year are paid to employees and independent contractors who performed the services in an OZ.
- The business's tangible property located in an OZ and the management or operational functions performed in the OZ are each necessary for the generation of at least 50% of the business's gross income.

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These safe harbors should help facilitate OZ investments into operating businesses that have the majority of their personnel located in an OZ.

#### **OZ Property Holding Requirement**

In addition to satisfying the income test, an operating business must hold at least 70% of its tangible property in qualified property located in an OZ ("OZ property"). OZ property is property purchased after December 31, 2017, from an unrelated party, if substantially all of the use of the property is in an OZ during substantially all of the time the business holds the property. The original use of the OZ property in the OZ must commence with the business. The new regulations provide several clarifications for how property may qualify as OZ property:

- Used property may qualify as long as the property was not previously placed in service in the OZ by any other person.
- Improvements made by a lessee to leased property in an OZ may qualify.
- Inventory or raw materials do not fail to qualify solely because they are in transit from a vendor into the OZ or from the business's location to a customer located outside of the OZ.
- Leased property may qualify if the lease was entered into after December 31, 2017, and substantially all of the property is used in an OZ during substantially all of the lease term.

#### **Conclusion**

The IRS's guidance for the "income test" and the OZ property holding requirement is important not only for individual investors and fund managers looking for OZ investments, but also for business owners seeking to raise capital and participate in the economic development the OZ program is expected to produce. Of course, full compliance with the OZ program's requirements involves complex decisions that should be made with the advice of knowledgeable professionals.

The next part in the series will discuss the provisions of the new regulations that affect real estate investments.