OPPORTUNITY ZONES

Additional Proposed Regulations Explained

The following outline is intended to summarize certain key provisions of the second set of proposed regulations as they relate to Qualified Opportunity Funds (QOF) issued by the US Department of the Treasury on April 17, 2019. It is not meant to be comprehensive and is subject to change.

- **QOFs are permitted to refinance debt and make interim cash distributions after two years.**

  The ability to refinance debt and distribute cash helps alleviate concerns about paying the tax liability on the original gain in 2026 and concerns about the ten-year holding period.

- **Investors are expected to benefit from favorable tax treatment of depreciation.**

  Depreciation is treated as a deduction against the income of a property and reduces a real estate investor's cost basis. When a property is sold for a gain, the accumulated depreciation is often treated as taxable income—this is called depreciation recapture. Under the proposed regulations, it is expected that both capital gain and depreciation recapture will be eliminated after the property is held for ten years. An investor can receive the benefits of depreciation in reducing taxes on cash distributions without having to worry about depreciation recapture upon a sale. This could have a significant impact on after-tax returns.

- **QOFs will have more time to invest their cash contributions.**

  QOFs must periodically pass asset tests to confirm that Opportunity Zone property comprises at least 90% of fund's assets. This had created concern that cash contributed shortly before the date of an asset test could cause a fund to fail to achieve the 90% threshold. The proposed regulations exclude cash contributed during the six months before the asset test dates, easing concerns that investments will be hurried simply to avoid penalties.

- **Partnership tax rules will apply to QOFs.**

  Partnership rules will apply to QOFs which means that gains and income will pass through directly to the individual investor in the QOF which can benefit QOFs that are structured as partnerships versus REITs.

- **A QOF may sell individual properties and receive favorable tax treatment any time after the ten-year holding period.**

  The IRS proposed a clarification that permits the manager of a QOF to divest assets in a straight-forward, orderly fashion. There was previously concern that a QOF might be required to dispose of all of its assets within the same year to receive favorable tax treatment. This highly anticipated clarification provides flexibility to dispose of assets to the right buyers at the right time instead of wholesale or requiring complex structuring.

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- **A QOF may sell properties before the ten-year holding period.**

  If a QOF divests a property before the ten-year holding period expires, the proceeds can be reinvested in another Opportunity Zone property with a twelve month period and there will be no adverse tax consequences.

- **The tax benefits of a QOF will transfer to heirs.**

  Upon the passing of a QOF investor, his or her heirs will receive the same tax benefits that the original investor would have received.

- **Any future changes to the Opportunity Zone statues and guidance cannot be applied retroactively.**

  While changes to the tax treatment of QOF cannot be applied retroactively, tax rates can change which can either positively or negatively affect investors.

- **Triple-net leases are disallowed.**

  These types of properties are considered “passive” and not eligible investments for a QOF.

Please let us know if you would like additional materials related to this topic, and we would be happy to share.
