IRS Issues Guidance on Qualified Opportunity Zones

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The 2017 Tax Cut and Jobs Act included significant new tax benefits for investments in qualified opportunity zones. Specifically, taxpayers can defer tax recognition on capital gains when the gains are reinvested in a qualified opportunity fund, which is a partnership or corporation that invests in qualified opportunity zones. In addition, the gains from the investment in the fund can be permanently eliminated if the investment is held for at least 10 years.

Qualified opportunity zones are a new concept, and tax practitioners and investors have been eagerly awaiting guidance on how these new rules will be implemented. The IRS released its first round of guidance on Friday, in the form of proposed regulations and a revenue ruling. This guidance clarified several important issues. For example, qualified opportunity zone property includes tangible property if the qualified opportunity fund substantially improves tangible property located in a qualified opportunity zone. It was unclear what this meant in the context of property such as a building. Revenue Ruling 2018-29 answers this question by providing that substantial improvement occurs when the cost of the improvements is equal to at least the adjusted basis in the building, rather than requiring the improvements to cost at least the adjusted basis in the building and the underlying land. In addition, the qualified opportunity fund is not required to separately substantially improve the land upon which the building is located.

The proposed regulations also clarify that a qualified opportunity fund does not need to be a newly formed entity, and that only capital gains qualify for this new tax regime. The regulations also clarify that 100% gain elimination (for gains occurring from the investment in the fund) is available if the investment is held for at least ten years, even if the designation of an opportunity zone expires prior to the ten year anniversary of the investment. This last piece of clarification addressed a significant concern of many tax practitioners, as the designation of all of the current opportunity zones expires December 31, 2028. The regulations also provide that taxpayers can generally rely on the proposed regulations at this time.

The regulations leave many questions unanswered for now as the regulations reserved several important issues, including what constitutes the active conduct of a trade or business and whether residential real estate qualifies. Stay tuned for further developments as additional guidance is issued.