Latest Regulations Expand Potentially Tax-Free Investment Opportunity

By Carol Wright, CPA

People interested in Qualified Opportunity Zone (QOZ) investments, which invest capital gains proceeds in economically underdeveloped areas and can earn tax-free returns, are now able to move forward with more certainty.

Earlier this month, the U.S. Treasury Department issued more proposed regulations on QOZ investments that helped clarify investor concerns and ease their hesitation. Here's what's new, along with information on how you may be able to capitalize.

Latest Updates Favorable for More Investors

With many of the rules now clarified, it's likely large public funds will form Qualified Opportunity Funds (QOF), which are the passthrough or corporate entities needed for QOZ investing, and jump in. The same can be said of investors in the real estate industry, where redevelopment is always a focus.

But the new rules open QOZ investing to more people than just large investors and real estate developers. Operating businesses like manufacturers, coffee shops and technology startups will be better able to benefit too.

Income Test Flexibility

Before the revisions, the IRS offered only one way to satisfy the program's gross income requirements. Now, QOZ investments can satisfy any of four gross income tests to qualify for tax advantages:

- Half or more of service hours worked are within the Qualified Opportunity Zone
- Half or more of the gross income derived is within the Qualified Opportunity Zone
- The tangible property and operations needed to generate half or more of the gross income reside within the Qualified Opportunity Zone
- Facts and circumstances indicating half or more of the gross income resides within the Qualified Opportunity Zone

Expanded Contributions

The new rules allow investors to contribute any property, not only cash, to a QOF. That will really help small businesses start up quickly. However, these contributions count only towards an interest in the fund, not as qualified business property of the QOZ business for testing purposes, and won't satisfy other asset-related requirements of the law.

Distribution Clarity

Treasury released an updated (non-exhaustive) list of transactions that would trigger a recognition of the deferred capital gain. It includes gifting the QOF interest, but not when it is passed on to beneficiaries through an estate.

Capital Gains Guidance

For tax purposes, QOZ investors holding their investments for 10 years or more can exclude capital gains earned from any business property sold by the QOZ business.

For investments held less than 10 years, capital gains earned by the fund can be reinvested within 12 months and still count as eligible property. The gains would flow through to the investor, however, other tax-planning such as like-kind exchange rules could defer the gain.

Inclusion of Leased Property

Leased property is now counted in qualification tests and can come from a "related person," which means investors who already own property in a QOZ as of December 31, 2017, can participate in the program. That said, the lease must be at fair market value to be eligible. This clarification helps currently operating businesses immensely and will smooth deal making.

Working Capital Safe(r) Harbor

The first big change to the working capital safe harbor rules involves the use of capital. Funds are required to hold qualified property, and cash doesn't qualify in general. However, a period of time is allowed to deploy this capital, and new funding is now exempt not only when it's held for property improvement, but also if it's to be used to develop a business.

A second new provision won't penalize firms for delays caused by waiting for government action (e.g., permits) during the 31-month working capital testing period.

No Finality, But Enough Progress to Move Forward

While they did provide much clarity, the new regulations are still quite detailed and complex. In future rounds, investors will continue to seek more certainty.

That said, it's clear this legislation is a huge tax incentive for small and middle-market businesses. And it's easy for them to participate because one thing the government definitely got right was the certification process. It's a self-certification, completed on a one-page form.

If you're interested in a QOZ investment or would like to learn more, Rehmann offers tax and business planning services to help evaluate potential opportunities. To get started today, please call Carol Wright, CPA, at 248.614.6454.