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**Practice Groups:****Public Policy and  
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## Opportunity Zone Proposed Regulations Provide the Certainty Anxious Investors, Developers, and Entrepreneurs Have Been Seeking

*Long-awaited guidance expected to trigger a surge of green-lighted projects as investors race to meet holding periods, creating competition for investment dollars and desirable OZ developments and businesses*

**By: Mary Burke Baker, Adam Tejeda, Olivia Byrne, and Kevin Klein**

The Department of Treasury has released eagerly anticipated proposed regulations on Opportunity Zones (“OZs”). Although OZ incentives were enacted months ago, investors, developers, entrepreneurs, and fund sponsors have been wary to commit to OZs because the statute left many key definitions and mechanical questions unanswered. While the regulations and related Revenue Ruling 2018-29 do not address every concern, the guidance provides enough answers for many to decide they now are ready to say “Yes” to OZs.

The terms and conditions of OZs remain complex even with proposed guidance. While the rewards of the OZ program have tremendous potential, missteps in implementation could result in loss of OZ benefits for investors, penalties for qualified opportunity funds (“QOF”), and more expensive capital for projects and businesses. Our K&L Gates cross-practice OZ team is prepared to help clients understand and implement the OZ program and maximize its benefits, and provide input to the Treasury Department (“Treasury”) and Capitol Hill, whether you are an investor, a developer or entrepreneur, or interested in setting up a fund. We invite you to contact us if you need assistance.

For background information regarding the basics of Opportunity Zones, see *below* and [Alert: Opportunity Zones - A Golden Opportunity?](#)

### WHAT QUESTIONS DO THE PROPOSED REGULATIONS ANSWER?



**Q. May a QOF and a Qualified Opportunity Zone Business be a limited liability company (“LLC”)?**

A. Both a QOF and a qualified OZ business classified as a partnership may be LLCs. A single-member LLC that will be treated as a disregarded entity for federal income tax purposes does not appear to qualify.

**Q. What constitutes original use for purposes of the tangible property test?**

A. The regulations reserve (delay for later) the definition of “original use,” and Treasury is asking for comments on whether tangible property that has been in disuse or underuse, or that will be used for a different purpose in an OZ, should be considered as original-use property.

Revenue Ruling 2018-29 clarifies that, given the permanent nature of land, the acquisition of land can never meet the original-use test. Further, the acquisition of an existing building located in an OZ also is not considered to meet the original-use test. However, when constructing a new building on vacant land in an OZ, land is not an applicable factor in determining whether the original-use test is met. This will significantly increase the number of projects that may qualify for OZ benefits.

**Q. Is the cost of land included in the adjusted basis of property for purposes of the substantial improvement test?**

A. The cost of land is excluded from the adjusted basis when determining whether substantial improvements have been made to a property. When renovating a building, only the adjusted basis of, and improvements to, the building are taken into account for purposes of the substantial improvement test. There is no requirement that substantial improvements be made to the land separately. Thus, if only land (rather than land and a building) is acquired, it appears that the development of a building on the land would not be subject to any substantial improvement benchmarks. This will significantly increase the scope and number of rehabilitation and other improvement projects qualifying for OZ benefits.

**Q. Is the 30-month period to complete substantial improvements a continuous period and when does it begin?**

A. The regulations do not provide for any breaks or pauses in the 30-month period, and they do not address what triggers the beginning of the 30-month period.

**Q. How much time does a QOF have to meet the 90-percent asset test after receiving capital gains from investors?**

A. The regulations provide a 31-month safe harbor for working capital held by a qualified OZ business provided that the qualified OZ business has a plan in place to deploy the capital and uses the working capital in a manner consistent with the plan. This will significantly reduce the risk of penalties for failing to meet the 90-percent asset test.

**Q. Does cash held as working capital by a qualified OZ business apply toward meeting the 90-percent asset test?**

A. To the extent that the working capital will be used for the acquisition, construction, and substantial improvement of qualified OZ property, it will count toward meeting the 90-percent asset test if expended within the 31-month safe harbor noted above and certain other conditions are met. If such working capital does not meet the terms of the safe harbor, such cash may still apply provided that it is expended within an 18-month period.

**Q. What percentage threshold will meet the various “substantially all” tests in the statute?**

A. The regulations define only the substantially all threshold for tangible property owned by qualified OZ businesses. Another round of proposed regulations expected to be issued in the near future are liable to provide the definitions for the remaining substantially all thresholds in the statute. To the extent that a qualified OZ business owns or leases tangible property, at least 70 percent of such property must be qualified OZ business property. In addition, the 70-percent test provides an incentive to invest in qualified

businesses through a lower-tier qualified OZ business rather than owning OZ property directly. For example, consider a QOF with \$1,000,000 in assets that intends to invest the assets entirely in real estate. If the QOF owned the assets directly, then in general at least \$900,000 (90 percent) of such assets must be in an OZ to satisfy the 90-percent QOF test. However, if the QOF owned the assets through a qualified OZ business and invested \$900,000 in the qualified OZ business, only \$630,000 of the assets of the qualified OZ business must be in an opportunity zone ( $\$900,000 * 70\%$ ).

**Q. What is the process for a QOF to certify to the Department of Treasury that it is in compliance with the requirements of the OZ program?**

A. A QOF may self-certify that it meets the OZ requirements. Form 8996, Qualified Opportunity Fund, can be used both for initial self-certification and for annual reporting of compliance. A draft version of Form 8996 was released contemporaneously with the release of the regulations and is available for comment by stakeholders.

**Q. Will investments made in a QOF through 2026 qualify for the 10-year tax-free treatment even though the Opportunity Fund designation expires as of 12/31/2028?**

A. Capital gains realized through 12/31/2026 qualify for the step-up in basis (i.e., tax-free treatment of capital gains on QOF investments held for more than 10 years). Investments may be made as late as June 29, 2027, taking into account the 180-day investment window.

**Q. How long is an investor allowed to hold an investment in a QOF before making the election to step-up basis?**

A. Taxpayers may hold their investments in a QOF through December 31, 2047. Treasury is requesting comments on alternative approaches that could extend this deadline.

**Q. Do any forms of capital gains not qualify for the deferral?**

A. The regulations define an eligible gain as any gain treated as a capital gain for federal income tax purposes that would be recognized for tax purposes prior to January 1, 2027, if not deferred under the terms of the OZ program. However, some forms of capital gains do not qualify, including offsetting position straddle capital gains (other than an offsetting-positions transaction in which all of the positions are section 1256 contracts). Eligible Section 1256 capital gains are determined as an aggregate, net amount for the year.

**Q. When does the 180-day period to invest in a QOF begin?**

A. In general, a taxpayer must invest in a QOF during the 180-day period beginning on the date of the sale or exchange giving rise to the gain. For partners investing partnership gains that are deemed capital gains, the 180-day period begins on the last day of the partnership's taxable year.

**Q. May pass-through entities invest directly in a QOF?**

A. Partnerships and other pass-through entities may invest directly in a QOF. Capital gains invested by a partnership are not included in the partners' distributive shares of taxable income for the taxable year in which such gains are invested in a QOF.

**Q. Can an existing entity become a QOF?**

A. An entity otherwise eligible to be a QOF ("eligible entity") may delay QOF status until a later date. The date the entity becomes a QOF must be provided as part of the self-certification on Form 8996.

**Q. What is the process for investors to disclose to the IRS that they have invested in the OZ program? How will the IRS enforce whether these investments actually were made? How will the IRS keep track of the deferred capital gains to ensure taxes are paid on them in 2026?**

A. It is expected that investors will attach Form 8949 to their tax returns for the year in which the gain would have been recognized if it had not been deferred due to an OZ. IRS compliance and enforcement procedures have not been announced.

**Q. Will a QOF have information return filing requirements?**

A. Treasury intends to address information reporting requirements of QOFs in the next round of regulations.

## **WHAT QUESTIONS DON'T THE PROPOSED REGULATIONS ANSWER?**

**Q. How much time does a QOF have to reinvest proceeds received from the sale of qualified Opportunity Zone stock and partnership interests, and from the sale of qualified Opportunity Zone business property?**

A. Soon-to-be released proposed regulations will provide guidance regarding allowable procedures for these reinvestments.

**Q. Do gains realized by a QOF qualify for the 10-year tax free treatment?**

A. Neither the statute nor the regulations clearly provide that gains realized by a QOF qualify for the 10-year tax free treatment. This means that ultimate exit events may need to be structured at the QOF level.

**Q. Does carried interest qualify for the 10-year tax free treatment?**

A. The regulations do not address whether carried interest qualifies for the step-up in basis. This may depend on whether gains realized by a QOF after the 10-year period qualify.

**Q. Are capital gains of the QOF taxable to investors in the year the capital gains are realized and may these capital gains be reinvested in the QOF without triggering a new holding period?**

A: Treasury is considering the income tax treatment of any gains that the QOF reinvests and will be soliciting comments from stakeholders in forthcoming proposed regulations. At this time, it appears that capital gains will flow up to investors and be currently taxable unless the gains are reinvested in a QOF. It is unclear whether the reinvestments would trigger new holding periods for purposes of OZ benefits. The regulations provide that a taxpayer can reinvest its originally invested capital gains upon disposition of the entire original investment in a QOF. The taxpayer has 180 days after the end of the tax year to reinvest.

**Q. May OZ benefits be combined with other federal, state and local incentives?**

A. The regulations do not contain any restrictions on the combination of OZ incentives with other federal, state, or local incentives.

**Q. Does a capital lease qualify as an acquisition for purposes of qualified OZ business property? If so, what does the duration of the lease need to be to qualify?**

A. The regulations do not address this question.

**Q. Does an existing business qualify for OZ incentives?**

A. Treasury is requesting comments on methods in which existing businesses located in an OZ might qualify for OZ incentives. At this time, pre-2018 businesses do not appear to qualify for OZ benefits.

**Q. Can the assets of a qualified OZ business be used outside the OZ without disqualifying those assets?**

A. Treasury is requesting comments on ways assets of a qualified OZ business, e.g., vehicles or equipment, might be used outside the OZ without disqualifying the assets for OZ benefits.

**WHAT ARE OPPORTUNITY ZONES AND WHY IS THERE SO MUCH INTEREST IN THEM?**

The Tax Cuts and Jobs Act created the OZ incentives offering significant tax benefits for investors to attract funding for development and businesses in low income areas. Qualifying activities include housing, commercial real estate, retail, manufacturing, distribution, hospitality, start-ups, incubators, research, energy, day-care, farming, and other active trades or businesses. Individuals, family offices, and businesses can delay paying federal income tax until 2026 — and enjoy up to a 15-percent increase in basis — on capital gains invested in QOFs that hold at least 90 percent of their assets in qualifying businesses or tangible property located in low income areas designated as OZs. In addition, capital gains on investments in the QOFs can be federal income tax-free if an investment is held for at least 10 years. The OZ program can reduce the cost of capital to make projects more viable and works well with impact investment objectives.

## THE BASICS OF OPPORTUNITY ZONES



## WHAT HAPPENS NEXT?

For the types of projects where certainty has been established and barriers to entry alleviated, a flurry of activity is expected as investors and developers try to beat the clock on investing deadlines and holding periods. Investors will be seeking projects meeting their investment goals and strategies. Developers and business owners will be green-lighting projects and seeking capital. Financial institutions and fund sponsors will be establishing funds. Strong demand and competition for dollars and projects will ensue as many funds, investors and developers race to be first to market.

Treasury has requested comments on specific questions. For these, and for circumstances not addressed by the proposed regulations or where the guidance falls short, Treasury has provided until December 20, 2018 for stakeholders to submit comments before work begins on final regulations. Treasury also intends to issue additional regulations in the near future addressing certain issues not yet considered. Congress is also interested in hearing concerns about the program. OZ incentives have strong bipartisan support and legislation to mitigate barriers to entry is possible.

Although the regulations are proposed and not final, taxpayers may rely on the proposed regulations for arrangements entered into until final regulations are promulgated.

The K&L Gates OZ team intends to publish a series of targeted alerts to address the applicability of OZ incentives to particular industries and areas of interest.

For more information, please contact the authors or visit our [website](#).

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