

Recent Developments Relating to Investments in Qualified Opportunity Zone Funds

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The Opportunity Zone provisions included in the 2017 Tax Cuts and Jobs Act provide an opportunity for investors in qualified opportunity funds (QOFs) to glean significant tax benefits—including potential deferral of tax payments and potential exclusion of gains. But, because of the restrictions associated with operating a QOF, investors and fund managers alike will face challenges in crafting and executing an investment strategy, monitoring such investments, and harvesting any gains. The authors detail the requirements that must be met in order to achieve the potential tax benefits—and to avoid penalties.

Introduction

The recently enacted Opportunity Zone provisions included in the Tax Cuts and Jobs Act (the “2017 Tax Act”),¹ passed in December 2017, provide an opportunity to exclude from tax up to 15 percent of the gain on the sale or exchange of capital assets, and to defer the remainder until no later than 2026, if one or more investments are made in a qualified opportunity fund (QOF) within 180 days.

The legislative purpose of the Opportunity Zone provisions is to assist investment and development by private capital in economically distressed areas within the U.S. through tax incentives. On June 18, 2018, the IRS issued Notice 2018-48,² providing a list of over 8,000 qualified zones in all 50 states, the District of Columbia, and the nation’s territories.³ Even though the designation of qualified opportunity zones (“Opportunity Zones”) is set

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¹ P.L. 115-97.

² 2018-28 IRB 9.

³ The map of all opportunity zones has been determined and is available online at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml.

to expire on December 31, 2028, a QOF will be treated as though the fund remained invested in Opportunity Zones (notwithstanding the geographic area's loss of status as a qualified opportunity zone).⁴

Many QOF issues left unresolved by the 2017 Tax Act were addressed by proposed Treasury Regulations (the "Proposed Regulations") that were issued in October 2018.⁵ The Proposed Regulations will not go into effect until they are adopted as final regulations, but the effective date provision provides that taxpayers may rely on the Proposed Regulations as long as the Proposed Regulations are applied in their entirety and in a consistent manner.⁶ The purpose of the effective date provision is to encourage taxpayers to invest in Opportunity Zones without waiting until final regulations are issued.

The ABCs of QOFs

Investing in a QOF potentially allows a taxpayer to roll over capital gain, to defer gain recognition (and thus the associated tax liability) until as late as 2026, to exclude from taxation a portion of such deferred gain, and to potentially exclude from taxation any appreciation realized on the investment in the QOF.

A taxpayer and the QOF must satisfy certain criteria in order for the taxpayer to obtain all of the potential tax benefits. The taxpayer must (1) reinvest capital gain (2) within 180 days of realizing such gain (3) into a QOF, (4) make a gain deferral election,⁷ and (5) satisfy certain holding period requirements.⁸ The QOF must self-certify as such and must invest at least 90 percent of its assets in qualified opportunity zone property ("Zone Property").⁹

The taxpayer can defer recognition of the rollover gain until the earlier of December 31, 2026, or when the interest in the QOF (the "QOF Interest") is sold or exchanged.¹⁰ If the QOF Interest is held for at least five years, 10 percent of the rollover gain will not be subject to federal income taxation.¹¹ If the QOF Interest is held for at least seven years, an additional 5 percent of the rollover gain (i.e., 15 percent of the rollover gain in total) will not be subject to federal income taxation.¹² If the QOF Interest is sold after 2026 before

⁴ See Preamble to REG-115420-18, Explanation of Provisions § V.B, 83 Fed. Reg. 54279, 54283 (Oct. 29, 2018).

⁵ REG-115420-18, 83 Fed. Reg. 54279 (Oct. 29, 2018).

⁶ See Preamble, *supra* note 4, § VII, at 83 Fed. Reg. 54286.

⁷ IRC § 1400Z-2(a)(1)(A).

⁸ IRC § 1400Z-2(b), (c).

⁹ IRC § 1400Z-2(d)(1).

¹⁰ IRC § 1400Z-2(b)(1).

¹¹ IRC § 1400Z-2(b)(2)(B)(iii).

¹² IRC § 1400Z-2(b)(2)(B)(iv).

meeting the 10-year holding period, the appreciation on the QOF Interest is subject to federal income taxation.

If the QOF interest is sold or exchanged after 10 years, the taxpayer can make an election that would effectively provide for tax-free treatment with respect to any appreciation in the QOF interest—that is, appreciation attributable to the time after acquisition of the QOF.¹³

Example: On July 4, 2018, Ivan Investor realized \$100 of capital gain. Ivan could invest \$100 into a QOF by December 31, 2018 (i.e., the 180th day after July 4), and not pay tax in 2018 on the \$100 of gain. If the QOF Interest is held for at least five years, but fewer than seven years, Ivan would pay tax on \$90 of the deferred gain when the interest in the fund is sold, and on any post-acquisition appreciation. If the QOF Interest is held for at least seven years, Ivan would pay tax on \$85 of the deferred gain on the earlier of when the interest in the fund is sold or December 31, 2026. If the QOF Interest appreciates to \$250 (i.e., \$150 of unrealized gain) and Ivan remained invested for at least 10 years, Ivan would recognize the \$85 of deferred gain in 2026, but could make a subsequent election that would provide for no further taxation on the sale or exchange of the interest in the QOF. If the sale or exchange of Ivan’s QOF Interest occurred after 2026 but before Ivan held the interest for 10 years, however, the \$150 of unrealized appreciation is taxable.

QOFs may be multi-investor managed funds or single investor vehicles. In either case, the QOF must self-certify as such and comply with the 90 percent Test (defined below). Compliance with the 90 percent Test requires the QOF to monitor its portfolio to ensure that its investments remain in Zone Property. Zone Property includes qualified opportunity zone stock (“Zone Stock”), a qualified opportunity zone partnership interest (“Zone Partnership Interest”), or qualified opportunity zone business property (“Zone Business Property”).¹⁴

Any Zone Business Property held by a QOF must either be original use or substantially improved.¹⁵ Substantial improvement generally means an additional investment in the property equal to the QOF’s initial basis in the property.¹⁶ Thus, if a QOF acquires improved real estate in a qualified Opportunity Zone, the fund would be required to substantially improve the

¹³ IRC § 1400Z-2(c).

¹⁴ IRC § 1400Z-2(d)(2).

¹⁵ IRC § 1400Z-2(d)(D)(i).

¹⁶ IRC § 1400Z-2(d)(D)(ii).

property by making a subsequent investment equal to or greater than the basis attributable to the building. In other words, the amount of basis attributable to the land is excluded from the determination of the amount that constitutes a substantial improvement.¹⁷

Potential Benefits to Investors

Comparing Prior Code Section 1031 With Opportunity Zone Funds. Prior to 2018, taxpayers could defer a portion, or all, of the gain realized from the disposition of a broad array of business and investment assets if the taxpayer exchanged the property for like-kind property.¹⁸ If taxpayers complied with the requirements of Section 1031,¹⁹ the gain realized on the like-kind exchange would have been deferred until the replacement property was sold, subject to any re-deferrals. Under Section 1031, gain deferral was not time limited, unlike the QOF rules, which limit the gain deferral until as late as 2026.

Section 1031 and the QOF rules share some characteristics. Both are premised, from a tax policy perspective, on the notion that taxation should not occur while the taxpayer's investment continues to be at risk. Both Section 1031 and the QOF rules impose re-investment timeframes. Just as there were issues as to what constituted like-kind property, there are issues as to what constitutes Zone Property.

In some cases, it is possible to roll over capital gain into a QOF where it was not possible to defer gain recognition under Section 1031. Under Section 1031, both before and after its amendment by the 2017 Tax Act, taxpayers could not defer gain from the sale of investment securities. On the other hand, investing in a QOF can permit the deferral of gain on the sale of investment securities, including gain realized indirectly through a partnership's sale.

New Deferral Provisions. Eligible taxpayers can defer paying tax on capital gain from investments if the taxpayer invests gain generated from the sale to an unrelated person of a capital asset (the "Historic Asset") within 180 days from the disposition of the Historic Asset in a QOF.²⁰ Prior to the issuance of the Proposed Regulations, there was a debate as to whether any

¹⁷ Rev. Rul. 2018-29, 2018-45 IRB 765; Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(8)(ii), (d)(4)(ii).

¹⁸ See former IRC § 1031, prior to amendment by P.L. 115-97. As amended by the 2017 Tax Act, IRC § 1031 is limited in scope to certain real estate transactions.

¹⁹ Section references in this article are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), unless explicitly stated otherwise.

²⁰ See Prop. Treas. Reg. § 1.1400Z-2(b)(1). Taxpayers that can potentially benefit from investing in a QOF include individuals, C corporations, RICs, REITs, partnerships, S corporations, and trusts and estates.

type of gain could be deferred, or whether the Opportunity Zone provisions were limited to deferral of only capital gain. The heading of Section 1400Z-2 refers to the rules for capital gains invested in Opportunity Zones, but the flush language of the statute refers simply to gain from the sale or exchange of any property. The legislative history of Section 1400Z-2 clearly refers to the deferral of capital gains that are reinvested in qualified property, and the Treasury Department and the IRS determined that Congress intended deferral only to apply to capital gain.²¹ The Proposed Regulations specify that only capital gains are eligible for deferral and potential exclusion.²²

The debate continues in some circles on the theory that a statute heading cannot limit the plain meaning of the statute's text as a matter of statutory construction. However, a taxpayer considering this course cannot rely on the Proposed Regulations since the effective date language states that they must be applied in their entirety.²³ Taxpayers cannot pick and choose which Proposed Regulations sections to apply and which to disregard.

The potential tax benefits to investors from the Opportunity Zone provisions may be significant:

- All of the capital gain realized on the disposition of the Historic Asset can be deferred until the earlier of the date of disposition of the QOF Interest or December 31, 2026.²⁴
- Up to 15 percent of the capital gain realized on the disposition of the Historic Asset can be excluded if the QOF Interest is held for seven years (only 10 percent if the QOF Interest is held between five years and seven years).²⁵ However, in order to obtain the additional 5 percent exclusion, the QOF must be acquired no later than December 31, 2019, thereby permitting it to have been held for seven years before the rollover gain is triggered on December 31, 2026.
- Any gain on the sale or exchange of a QOF Interest can be tax-free if the QOF Interest is held for longer than 10 years and a subsequent election is made.²⁶ (If the QOF has declined in value by the time it is sold, then by not so electing, the taxpayer can preserve its higher basis and claim a capital loss for tax purposes.)

²¹ Preamble, *supra* note 4, § I.A, 83 Fed. Reg. at 54280.

²² Prop. Treas. Reg. § 1.1400Z-2(a)-1(b)(2).

²³ See Preamble, *supra* note 4, § VII, 83 Fed. Reg. at 54286.

²⁴ IRC § 1400Z-2(b)(1).

²⁵ IRC § 1400Z-2(b)(2).

²⁶ IRC § 1400Z-2(c). This election is available until December 31, 2047, which is 20.5 years after the latest date a taxpayer may make a gain deferral election. In this situation, the deferred gain would already have been recognized in 2026.

Eligible Gains and Rollovers. As noted, gains that can be deferred by investing in QOFs must be capital gains that arise from a sale or exchange with an unrelated person.²⁷ It does not matter whether the capital gains are short-term or long-term. Eligible gains include gains from the sale of investment securities and Section 1256 net capital gains realized at year end.²⁸ In addition, if the taxpayer sells his QOF Interest before 2026 (triggering gain recognition), he can re-invest such gains in another QOF and make another gain deferral election.²⁹ Deferred gains retain their character.³⁰ For example, if a taxpayer defers short-term capital gain, Section 1256 net capital gain, or capital gain on the sale of collectibles by reinvesting such gain in a QOF, once a portion, or all, of the gain is required to be recognized, it will retain its character as short-term capital gain, Section 1256 gain, or collectibles gain, respectively.³¹

A partnership can roll over its capital gain into a QOF within 180 days of the date the partnership realized the gain.³² Where a partnership does not elect to roll over its gain, a partner can roll over his or her distributive share of the partnership's capital gain.³³ The 180-day reinvestment window with respect to allocated capital gain from a partnership begins on the last day of the taxable year of the partnership.³⁴ Alternatively, the partner can elect to use the partnership's 180-day reinvestment window as his or her own reinvestment window rather than waiting until year end.³⁵ Analogous rules apply to S corporations and other pass-through entities.³⁶ This may be advantageous if a taxpayer needs capital gain to roll over into a QOF sooner rather than later.

Basis in a QOF Interest. The gain recognition schedule initially determines the taxpayer's basis in his or her QOF Interest. When rollover gain is initially invested in a QOF and a gain deferral election is made, the taxpayer's initial basis in the QOF Interest is zero.³⁷ If the QOF Interest is held for five years, the taxpayer's basis in that QOF Interest increases to

²⁷ IRC § 1440Z-2(e)(2); Prop. Treas. Reg. § 1.1400Z-2(a)-1(b)(2).

²⁸ Prop. Treas. Reg. § 1.1400Z-2(a)-1(b)(2).

²⁹ Prop. Treas. Reg. § 1.1400Z-2(a)-1(b)(4)(ii) (Ex. 4).

³⁰ Prop. Treas. Reg. § 1.1400Z-2(a)-1(b)(5).

³¹ Prop. Treas. Reg. § 1.1400Z-2(a)-1(b)(8) (Exs. 1-3).

³² Prop. Treas. Reg. § 1.1400Z-2(a)-1(c)(1).

³³ Prop. Treas. Reg. § 1.1400Z-2(a)-1(c)(2)(ii).

³⁴ Prop. Treas. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(A).

³⁵ Prop. Treas. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(B).

³⁶ Prop. Treas. Reg. § 1.1400Z-2(a)-1(c)(3).

³⁷ IRC § 1400Z-2(b)(2)(B)(i).

10 percent of the amount of the deferred capital gain from the Historic Asset.³⁸ If the QOF Interest is held for seven years, the taxpayer's basis in the QOF Interest increases by an additional 5 percent of the amount of the deferred capital gain.³⁹ On the earlier of when the Opportunity Zone Fund interest is sold or December 31, 2026, the basis in the QOF Interest is further increased to the full amount of the deferred gain that was rolled into the QOF.⁴⁰ Finally, if the QOF Interest is held for at least 10 years, when it ultimately is sold or exchanged, the taxpayer can elect to step up his basis in the QOF Interest to its fair market value on the date of the sale or exchange, effectively eliminating income tax on the QOF Interest (other than the rollover gain already recognized in 2026).⁴¹ If the value of the Opportunity Zone Fund declines, then the decline will reduce the rollover gain that has to be recognized on December 31, 2026.⁴²

Figure 1 depicts the tax treatment of an investment in QOF Interests. In Figure 1, the white box (far left) represents an investor's tax basis in the Historic Asset, the gray boxes (both the light and dark gray boxes) represent the gain realized on the disposition of the Historic Asset, and the black box (far right) represents the appreciation on the QOF Interest. If the QOF Interest is held for at least five or seven years, then the investor can step-up his basis in the Historic Asset by 10 percent of the deferred gain after five years and an additional 5 percent after seven years. In other words, the gain depicted in light gray will not be subject to federal income taxation after seven years. If the investor does not sell or exchange the QOF Interest for at least 10 years, the amount of gain depicted in the black box will not be subject to federal income taxation when the QOF Interest is sold or exchanged.

Practice Notes. The potential tax benefits from investing in a QOF are not available unless the taxpayer is investing untaxed gains and a deferral election has been properly made.⁴³ Where a taxpayer makes an investment with mixed funds—i.e., invests money, some but not all of which represents deferred gains—the investment is bifurcated and treated as two separate investments in the QOF, one as a QOF Interest and the other as an investment governed by the non-QOF Code provisions.⁴⁴ The potential tax benefits described above would only be available with respect to a QOF Interest for

³⁸ IRC § 1400Z-2(b)(2)(B)(iii).

³⁹ IRC § 1400Z-2(b)(2)(B)(iv).

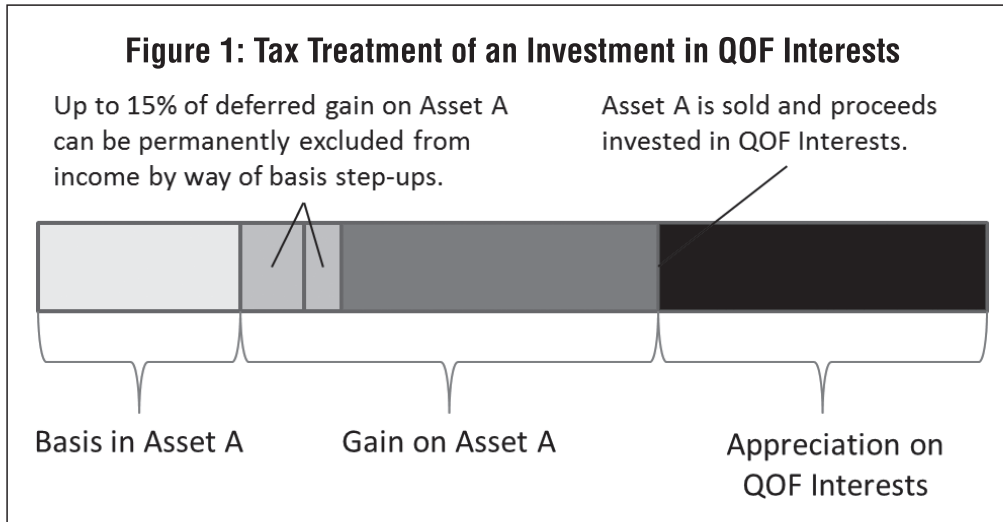
⁴⁰ IRC § 1400Z-2(b)(2)(B)(ii).

⁴¹ IRC § 1400Z-2(c).

⁴² IRC § 1400Z-2(b)(2)(A).

⁴³ IRC § 1400Z-2(a).

⁴⁴ IRC § 1400Z-2(e)(1); Prop. Treas. Reg. § 1.1400Z-2(c)-1(a).



which a gain deferral election has been properly made (i.e., the portion attributable to the gain rollover). For example, if cash representing a taxpayer's initial basis in the Historic Asset (white box in Figure 1) were invested alongside cash representing gain on the sale of the Historic Asset (gray boxes in Figure 1), the portion attributable to initial basis in the Historic Asset would be treated as a separate investment in the QOF but not eligible for the potentially advantageous tax treatment afforded to roll over eligible gains in QOFs.

Investors should be aware of certain requirements that must be met to obtain the tax benefits associated with QOFs:

- Generally, the taxpayer must sell or exchange a Historic Asset so as to trigger the realization of capital gain. If done via an exchange, cash in an amount equal to the deferred gain may be invested in the QOF since no tracing of sale proceeds is required by the QOF rules.
- The gain from the disposition of the Historic Asset must be invested in one or more QOFs within 180 days of the disposition of the Historic Asset.⁴⁵
- The amount of gain that can be deferred is limited to the amount that is invested in one or more QOFs.⁴⁶
- Finally, this deferral regime is elective, requiring taxpayers to make an election to defer gains on IRS Form 8949.⁴⁷ Without an affirmative

⁴⁵ IRC § 1400Z-2(a)(1)(A).

⁴⁶ Id.

⁴⁷ IRC § 1400Z-2(a)(1); IRS, Opportunity Zones Frequently Asked Questions, available at <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions> [hereinafter IRS FAQ].

election by the investor attached to his federal income tax return, eligible capital gain cannot be deferred.

Subchapter K Question. It is not entirely clear how portions of Subchapter K of the Code interact with the Opportunity Zone rules. Partners are generally taxed on their allocable shares of partnership income, and such income or loss allocations will increase or decrease the partners' outside bases in their partnership interests. There is no mechanism in the Opportunity Zone Code sections or the recent Proposed Regulations that would have the effect of overriding Subchapter K—that is, partners in a QOF that is a partnership will be taxed on the income of the fund even in the absence of a cash distribution. It is unclear how certain allocations or distributions—for example, cash distributions in excess of outside basis that would generally be treated as capital gain—will be applied for QOF purposes when a taxpayer has held his or her QOF Interest for longer than 10 years. In addition, if a partnership QOF sells its assets and liquidates, the partners potentially could be allocated a significant amount of income, which may erode or prevent the intended tax benefit of investing in QOFs. This issue is discussed below.

Challenges Related to Forming and Managing Opportunity Zone Funds

While the potential tax benefits to investors in QOFs can be significant, fund managers must comply with tax rules related to QOF and Opportunity Zone investing.⁴⁸ Because of the potential tax benefits, an argument can be made that expected investment returns from professionally managed QOFs will be lower than returns from other private investment funds, analogous to the difference in yields between tax-free bonds and taxable bonds.

General Contributions to a QOF. A QOF is an investment vehicle that is established as either a corporation or a partnership for the purpose of investing in Zone Property.⁴⁹ A QOF does not need to be a newly created entity.⁵⁰ A QOF can be established as an LLC that is classified as a partnership or corporation for federal income tax purposes.⁵¹ In addition, a QOF can also be

⁴⁸ Because QOFs are investment vehicles, QOFs and their managers must also be aware of, and comply with, non-tax laws and regulations applicable to the management of (and offering of interests in) investment funds (e.g., federal and state securities laws).

⁴⁹ IRC § 1400Z-2(d)(1). This purpose should be written into a corporation's articles or by-laws or a partnership's certificate of formation or its operating agreement.

⁵⁰ Prop. Treas. Reg. § 1.1400Z-2(d)-1(a)(3).

⁵¹ Prop. Treas. Reg. § 1.1400Z-2(d)-1(e)(1). See also IRS FAQ, *supra* note 47.

a REIT or an S corporation.⁵² The constituent documents (for example, the operating or partnership agreement or the by-laws and/or articles of incorporation or certificate of formation) of a QOF should reference its purpose to serve as such. The preamble to the Proposed Regulations indicates a QOF should use IRS Form 8996 to self-certify as to its status as a QOF.

According to the tax rules, a QOF does not need to be professionally managed. Both a single individual, via an S corporation, and two or more individuals, via a partnership, can form a QOF, provided such individuals comply with the QOF rules.

Meeting the 90 Percent Test. Ninety percent of the QOF's assets must be Zone Property (the "90 Percent Test").⁵³ The 90 Percent Test is based on the ratio of the average value of Zone Property to total assets held at the midpoint and the end of the QOF's taxable year. Generally, this means June 30 and December 31 for calendar-year funds.⁵⁴ The 90 Percent Test is applied by using asset values as reported on an audited financial statement⁵⁵ or by using the asset cost if no such financial statement is available. A monthly penalty will be imposed where a QOF is unable to satisfy the 90 Percent Test.⁵⁶ The penalty is equal to 5 percent of the difference between 90 percent of the value of the QOF's assets and value of the QOF's Zone Property.

Investment fund managers may wish to create a pipeline to source Zone Property to anticipate the compliance needs of the 90 Percent Test and avoid the potential associated penalty. In addition, fund managers may wish to negotiate for certain information rights with portfolio investments, allowing the QOF to self-certify as to the 90 Percent Test. Fund managers should also consider when assets are being sold, as the sale of Zone Property prior to mid-year or year-end may have a potentially adverse impact on the 90 Percent

⁵² Although it is not clear from language in the proposed Treasury regulations, the instructions to draft IRS Form 8996 make clear that a QOF can be a REIT or an S corporation.

⁵³ IRC § 1400Z-2(d)(1).

⁵⁴ *Id.*

⁵⁵ Prop. Treas. Reg. § 1.1400Z-2(d)-1(b) (cross-referencing Treas. Reg. § 1.475(a)-4(h)). Generally, an applicable financial statement is an audited financial statement that is submitted to the SEC, submitted to a federal agency (other than the SEC or the IRS), or significantly used in most of the significant management functions of the business. In the last case, only audits that receive either an unqualified or certain qualified opinions will qualify as an "applicable financial statement." Most Opportunity Businesses will not be submitting financials to the SEC and may not have a full audit conducted annually. Therefore, most QOFs may not be able to use financial statement values for purposes of the 90 Percent Test. Also, audited financials are only provided once a year whereas Eligibility Investment certifications must be done twice a year.

⁵⁶ IRC § 1400Z-2(f).

Test. For example, a sale on June 15 could have an impact on the June 30 balance sheet for purposes of computing average asset value for the 90 Percent Test. Due to the need for investors to time elections based on the date of sale of their Historic Assets and application of the 90 Percent Test and its associated penalty, single-asset QOFs for significant investors may be more manageable than QOFs with diversified portfolios targeting multiple investments that are relatively smaller in amount.

Zone Property Defined. Zone Property includes (1) Zone Stock, (2) Zone Partnership Interests, and (3) Zone Business Property.⁵⁷ Zone Property does not include investments in other QOFs.⁵⁸

Equity in Opportunity Businesses. Zone Stock means stock in an entity that is treated as a corporation that is formed in the U.S., including its possessions, and that:

1. Had its stock acquired by a QOF at its original issuance after December 31, 2017, solely for cash;
2. At the time its stock was issued, was in a Zone Business or formed for the purpose of investing in a Zone Business; and
3. During substantially all of the QOF's holding period of the Zone Stock, qualified as a Zone Business.⁵⁹

Similarly, a Zone Partnership Interest is an interest in a domestic entity treated as a partnership that:

1. Had its partnership interests acquired after December 31, 2017, solely in exchange for cash;
2. At the time such interest was acquired, was a Zone Business or was formed for the purpose of investing in a Zone Business; and
3. During substantially all of the holding period of the QOF Interest, was a Zone Business.⁶⁰

Although Zone Stock or Zone Partnership Interests must have been acquired at their original issuance, the issuing entity can be an existing

⁵⁷ IRC § 1400Z-2(d)(2).

⁵⁸ IRC § 1400Z-2(d)(1).

⁵⁹ IRC § 1400Z-2(d)(2)(B)(iii).

⁶⁰ IRC § 1400Z-2(d)(2)(C)(iii).

enterprise so long as it is issuing new equity (for example, a new share class or new class of partnership or membership interests).⁶¹

For purposes of Zone Stock and Zone Partnership Interests, the issuer must be engaged in a qualified opportunity zone business (“Zone Business”).⁶² A Zone Business is a trade or business in which:

1. Substantially all of the tangible property of the business is Zone Business Property;⁶³
2. At least 50 percent of the gross income is derived from the active conduct of such business;⁶⁴
3. A substantial portion of any intangible property of such entity is used in the active conduct of such business;⁶⁵
4. Less than 5 percent of the aggregate unadjusted bases of all property of the business is in “nonqualified financial property” (which does not include working capital held in cash, cash equivalents, and short-term debt instruments or accounts receivable);⁶⁶ and
5. No business operation consists of a private or commercial golf course, country club, massage parlor, hot tub facility, sun tanning facility, racetrack or other gambling facility, or liquor store.⁶⁷

A business operated partially within and partially outside qualified Opportunity Zones should be treated as an Opportunity Zone Business if at least 70 percent of the business’s tangible assets are used in an Opportunity Zone.⁶⁸

Investments in Zone Business Property. Zone Business Property means any tangible property used in a trade or business of the QOF if:

1. Such property was acquired by the QOF by purchase after 2017;
 2. The original use of such property in an Opportunity Zone began with the QOF, or the QOF substantially improved the property;
- and

⁶¹ See Preamble, supra note 4, § VI.D, 83 Fed. Reg. at 54284.

⁶² IRC §§ 1400Z-2(d)(2)(B)(i)(II) and (C)(ii).

⁶³ IRC § 1400Z-2(d)(3)(A)(i).

⁶⁴ IRC § 1400Z-2(d)(3)(A)(ii) (referencing IRC § 1397C(b)(2)).

⁶⁵ IRC § 1400Z-2(d)(3)(A)(ii) (referencing IRC § 1397C(b)(4)).

⁶⁶ IRC § 1400Z-2(d)(3)(A)(ii) (referencing IRC § 1397C(b)(8)).

⁶⁷ IRC § 1400Z-2(d)(3)(A)(iii) (referencing IRC § 144(c)(6)(B)).

⁶⁸ Preamble, supra note 4, § VI.G, 83 Fed. Reg. 54284–85.

3. During substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a Qualified Opportunity Fund.⁶⁹

Substantial improvement means an additional investment in improvements within 30 months of acquiring the property that is equal or greater to the adjusted basis of the property at the time of acquisition.⁷⁰ The Proposed Regulations provide that substantial improvement to a building is determined with reference to the QOF's basis in the building only (i.e., the amount of additional investment does not take into account the amount of basis attributable to any land the building is on).⁷¹

As noted, during the holding period of the Zone Business Property, substantially all of the use of such property must take place in one or more Opportunity Zones.⁷² This "substantially all" requirement will be satisfied if the property is used 70 percent of the time in one or more Opportunity Zones.⁷³

The Proposed Regulations' definition of "substantially all" for this purpose is very significant. To the extent that a QOF invests through a joint venture that issues Zone Partnership Interests, the QOF can have only 63 percent of its assets invested in a qualified Opportunity Zone, whereas, if it invested directly, 90 percent of its assets must be so invested. In this scenario, the QOF would invest 90 percent of its cash into Zone Partnership Interests issued by the joint venture entity, and the joint venture uses 70 percent of its assets in Opportunity Zones.

The Preamble to the Proposed Regulations reveals that the IRS is aware of this slippage.⁷⁴ It notes that the definition does not apply elsewhere. It is possible that the final regulations may not be so generous. The Preamble states that the compounded use of "substantially all" must be interpreted in a manner that does not result in a fraction that is too small to implement the will of Congress. The Treasury Department and the IRS requested comments regarding the proposed meaning of "substantially all" for all Opportunity Zone purposes, including for the purpose of determining what is "substantially all" of the tangible property owned or leased in a trade or business.

⁶⁹ IRC § 1400Z-2(d)(2)(D).

⁷⁰ IRC § 1400Z-2(d)(2)(D)(ii).

⁷¹ Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(8)(ii), (d)(4)(ii). See also Rev. Rul. 2018-29, *supra* note 17.

⁷² IRC § 1400Z-2(d)(2)(D)(i)(III).

⁷³ Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(3).

⁷⁴ Preamble, *supra* note 4, § VI.G, 83 Fed. Reg. at 54284-85.

Issues at Wind-Up. As discussed above, the appreciation on QOF Interests can be tax-free. However, if a QOF is structured as a pass-through entity, the investors could be allocated gains as the fund sells off assets rather than benefiting from tax-free treatment. Until future regulations solve this issue, sponsors of QOFs may want to develop strategies in anticipation.

Conclusion

In summary, a QOF can provide significant tax benefits to investors, including potential deferral of tax payments and potential exclusion of gains. Given the restrictions associated with operating a QOF, investors and fund managers face potentially significant challenges in crafting and executing an investment strategy, monitoring such investments, and harvesting any gains. Both investors and fund managers also must comply with tax reporting obligations to achieve potential tax benefits and to avoid penalties related to investing and operating QOFs.

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