Tax Alert

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Opportunity Zones: New Guidance Sheds Light on How Private Equity Industry Can Take Advantage

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Key Points

- Proposed regulations issued on October 19 provide welcome guidance to asset managers regarding the formation of qualified opportunity funds (QOFs) that may provide investors with the following three tax benefits: (1) deferral of tax on realized gains until December 31, 2026; (2) partial tax exemption for same realized gains (at year five and year seven); and (3) full tax exemption on gains attributable to future appreciation for certain long-term investments (after 10 years). QOFs present opportunities specifically for real estate focused sponsors and their investors.
- All capital gains, including short-term (which covers gains with respect to carried interest) are eligible for the tax benefits if timely rolled into a QOF; commodities traders should note that aggregate net capital gains arising from Internal Revenue Code Section 1256 contracts are also generally eligible.
- Existing investment fund structures could potentially be utilized, provided a fund's drawdown mechanics cause investors seeking the tax benefits to be invested in a QOF within 180 days of the relevant gain triggering event. The QOF itself must ensure semi-annually that 90 percent of its assets are invested in qualified opportunity zone (QOZ) property (including stock or partnership interests in a QOZ business). Newly certified QOFs have as long as six months after first closing (less if a calendar-year QOF chooses a month after June as its first month as a QOF) to satisfy the 90-percent test.
- The new rules are generous in that they effectively give QOZ businesses 31 months before they will be limited to holding less than 5 percent in working capital assets (assuming they satisfy the safe harbor), limit the substantial improvement requirement to only doubling the basis of existing buildings (excluding the basis of the underlying land) and provide generous rules regarding calculation of the 180-day test for gains recognized through partnerships.
- Exit events will need to be carefully structured to maximize available tax benefits, and such benefits should generally be available until 2047.

- Additional forthcoming regulations are expected to address remaining areas of uncertainty (in particular, rules that could more easily allow for multi-asset funds to maximize the tax benefits on exits from individual assets).

Sophisticated investors eager to roll their realized gains into QOFs got answers to some of their most pressing questions on October 19, when the U.S. Department of Treasury (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations. The guidance contains approximately 44 pages of preliminary explanation and 30 pages of draft rules, some of which can be relied upon immediately (giving asset managers the certainty they have been seeking as they set up their funds). The regulations are subject to notice and comment, and could be modified prior to finalization.

The opportunity zone provision, found in Internal Revenue Code Sections 1400Z-1 and 1400Z-2, and signed into law as part of the Tax Cuts and Jobs Act (TCJA, P.L. 115-97), gives investors the ability to defer and reduce the taxes otherwise owed on capital gains as long as they are rolled over into investments in certain low-income communities (QOZs). The provision is drafted broadly enough that it has generated significant interest from the fund community, with tens of billions of dollars of new capital expected to flow into QOZs each year.

But the provision was also drafted in such a way that it has caused significant amounts of uncertainty with respect to critical threshold issues, such as what types of gains are eligible for the tax benefits, whether the general prohibition against fund-of-funds structures can be navigated and what happens when an opportunity fund uses leverage.

In this alert, we will explain how the new guidance provides clarity across the following four areas:

1. Tax Benefits for Investors (U.S., non-U.S. and tax exempts)
2. QOF Structure (potential two-tier holding structure)
3. Fund Mechanics (how to satisfy the rules while considering exit needs)
4. Contractual Exposure to Investors (compliance and penalty issues).

1. Tax Benefits for Investors

The statutory opportunity zone provision offers investors in QOFs three U.S. Federal income tax benefits:

1. **Deferral of certain eligible gains:** An investor with taxable capital gain from a sale of property before January 1, 2027, to an unrelated party, can defer paying tax on the gain by investing it into a QOF (within 180 days of triggering the gain) and making an election for deferral (on IRS Form 8949). (Although, as a practical matter, to get any real economic benefit from the deferral, gains would need to be realized before January 1, 2026.) The deferral generally lasts until December 31, 2026 (subject to points two and three below), or, if earlier, upon the disposition of the investor's interests in the QOF.
2. **Partial nonrecognition of rollover gains after five and seven years:** At the time the deferral ends, any gains that were originally rolled over and for which an election for deferral was made (or, if less, the fair market value of the relevant

rollover investment) must be included in income, but any gains recognized at such time can be reduced through a basis step-up of up to 15 percent if the investor stays invested in the QOF for seven years (10 percent basis step-up at year five, with an additional 5 percent basis step-up at year seven). Because the deferral of rollover gains ends in 2026, taxpayers seeking the full 15 percent basis step-up benefit should invest in a QOF by December 31, 2019.

3. **No gain recognition on future appreciation upon sale or exchange of a QOF interest after 10 years:** Investors may benefit from a full basis step-up to fair market value upon disposition of a QOF interest (assuming the interest was subject to the deferral election described above) if the interest was held for at least 10 years. If this holding period is met, essentially all post-acquisition economic appreciation associated with the QOF investment may be tax-free (with no cap on the amount of appreciation eligible for this benefit). (We also note that depreciation recapture and other items of "ordinary gains"—such as Section 751 hot-assets—are presumably excluded from taxation under this provision, although the regulations do not provide clarity on this point.) Because this tax benefit is provided by the mechanism of a basis step-up at the investor level (without a corresponding step-up at the QOF-level), careful planning should be made with respect to exits in order to allow full utilization of this tax benefit by the investors.

The Types of Gains That May Be Deferred

While it is clear that qualifying gains must have been realized from the sale or exchange of property to an unrelated party occurring before January 1, 2027, the statute does not make clear whether the gains must be long-term capital gains or whether gains that are subject to depreciation recapture and gains that are taxed at ordinary income rates (such as short-term capital gains or so-called carried interest) are also eligible for the tax benefits. This fundamental uncertainty has caused many investors to wait for guidance.

The proposed regulations clarify that *all* capital gains (that is, gains from the sale or exchange of a capital asset defined in Section 1221, as well as—presumably—capital gains under Section 1231) are eligible for deferral. This also means that short-term capital gain (gain that, in the hands of an individual, is subject to tax at ordinary rates) will be eligible for the tax benefits provided by the opportunity zone provision. Importantly, there is no netting requirement with respect to these capital gains (provided that it is not part of an "offsetting positions transaction," such as a straddle, in which case the gain is ineligible for deferral), so any such gains that are triggered can benefit from deferral even if they otherwise would have netted out to zero over the course of the year and across all of the taxpayer's investments.

The ability to roll over short-term capital gains is likely of increased importance to fund sponsors given that recent tax reform resulted in increased potential for short-term capital gains in respect of carried interest. The regulations also provide that capital gains arising from Section 1256 contracts are eligible for deferral. However, in this case, the amount of the gain is determined on the last day of the taxable year on an aggregate net basis (resulting in 60 percent long-term and 40 percent short-term).

Any ordinary income gains (which may include depreciation recapture, Section 1248 dividends and gains on the sale of a partnership interest attributable to Section 751 hot assets) are not eligible for deferral under the QOZ provisions.

When the deferral ends (at the earlier of December 31, 2026, or when the investor exits the QOF), the character of the rollover gain (whether short or long-term) will be the same as it would have been had the deferral election not been made. Not only is the character passed through, but the regulations explicitly preserve all of the deferred gain's other tax attributes including under Sections 1(h), 1222 and 1256.

This means that any short-term capital gain that was deferred would presumably be taxed at the ordinary rate applicable at December 31, 2026 or, if earlier, upon disposition of the investor's interest in the QOF. The holding period of the QOF investment does not change the character of the rollover gain.

However, a taxpayer cannot elect to defer rollover gain twice. Once a taxpayer has invested its qualified gain into a QOF and made an election for deferral, it generally cannot then exit the QOF and reinvest the same gain into another QOF without triggering the gain. However, part of the gain can be part of one QOF and another part of the gain can remain uninvested or invested in a different QOF.

The Types of Investors That Are Eligible to Elect Deferral

While there are limits on the types of gain eligible for the opportunity zone tax benefits, many different types of investors can take advantage of the provision. Individuals, C corporations (including real estate investment trusts (REITs) and regulated investment companies (RICs)), partnerships, S corporations, trusts, and estates can all invest in a QOF and make an election for gain deferral. It does not matter that the taxpayer is foreign or domestic. The key determinant is whether the gain would be recognized under Federal tax law absent the QOZ provisions.

The regulations provide that any taxpayer that recognizes capital gain for Federal income tax purposes is eligible to invest in a QOF and elect deferral under the QOZ rules. This includes partnerships and certain other pass-through entities, in which case either the entity (e.g., the partnership) or the ultimate taxpayer (e.g., the partner)—but not both—can elect deferral for an item of capital gain. It would be prudent for fund sponsors to ensure that consistent reporting positions are taken in this regard.

Eligible investors generally also include non-U.S. and tax exempt investors (if the gain would be effectively connected with a U.S. trade or business (effectively connected income (ECI)) or unrelated business taxable income (UBTI)). Particularly for non-U.S. investors, if they have eligible capital gain to roll over into a QOF, then the QOF regime may provide them with a tax efficient structure through which they can invest in U.S. real estate or a U.S. operating business.

The Reinvestment and Election Requirement

The tax benefits under the QOF regime are only available if the deferred capital gain is invested in a QOF within 180 days (the 180-day test). Unlike the requirement in the related Section 1031 like-kind exchange rules, the opportunity zone's 180-day test is fairly generous in that the taxpayer has discretion to do what it wishes with the proceeds from the gain after the gain is realized and before it is rolled over into a QOF. No intermediary is required to maintain control over the funds until the trade is completed, and no tracing of the sales proceeds to the investment in the QOF need be made. In addition, the proposed regulations allow the 180-day period to be effectively extended to the extent the deferred gain is realized by a partnership and the deferral election is made by the partners in such partnership, as opposed to the partnership itself.

In general, the statute contains a bifurcation rule that gives investors the ability to roll both qualified and unqualified gains into a QOF. While only qualified gains are eligible for the three tax benefits outlined above, unqualified gains can still be invested in the fund. The proposed regulations also make clear that if a taxpayer takes a portion of the gain and invests it in a QOF, making an election for deferral, it can still choose to make an election for deferral with respect to the remaining gain for which no election has yet been made (although in any case, the 180-day test applies).

Treasury and the IRS have also determined that, in the case of a QOF that is taxed as a partnership, deemed contributions under Section 752(a) do not constitute additional investments in the QOF. This issue might arise when a partnership takes on liabilities and allocates a portion of the debt to its partners, increasing their outside basis in the partnership.

Finally, the proposed regulations clarify that debt investments in QOFs do not qualify for the tax benefits. On the other hand, an equity interest issued by a QOF can be used as collateral for a loan without ending the deferral.

2. QOF Structure

A prerequisite to securing any of the tax benefits described above is that the relevant investments must be made in a QOF. A QOF is (i) any investment vehicle, (ii) formed as a corporation or partnership, (iii) organized in one of the 50 states, the District of Columbia, or in the United States possessions, (iv) for the purpose of investing in QOZ property (other than another QOF).

The proposed regulations clarify the entity must also be classified as either a corporation (presumably including an S corporation if so eligible) or a partnership for Federal income tax purposes—so no disregarded entities. Limited liability companies (LLCs) treated as partnerships for tax purposes are also eligible (as long as they are not single member LLCs, which are treated as disregarded entities). REITs and RICs also appear eligible to be QOFs. Further, the proposed regulations provide that preexisting entities may qualify as QOFs as long as they satisfy the statutory requirements.

QOZ property can either be:

- QOZ business property (tangible property—either new or substantially improved—used in a trade or business of the QOF or QOZ business, purchased by the QOF or QOZ business from an unrelated party after December 31, 2017, and held for use in the QOZ),
- QOZ stock (stock of a U.S. corporation that is a QOZ business) or

- QOZ partnership interests (capital or profits interests in a U.S. partnership that is a QOZ business).

While it was not entirely clear whether preferred QOZ stock or QOZ partnership interests with special allocations qualified as QOZ property, the proposed regulations provide that they do.

A QOZ business is, generally, a trade or business in which substantially all (which the proposed regulations define as at least 70 percent) of the tangible property owned or leased by the taxpayer is QOZ business property (with certain stipulations related to the amount of active trade or business income, the use of intangible property, and the amount of property attributable to nonqualified financial assets, such as cash and cash equivalents).

Subject to the above requirements, any type of business—including residential or commercial real estate development—can potentially qualify as a QOZ business (although there is an exclusion for certain so-called "sin" businesses such as golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks, gambling facilities, and liquor stores).

Because the opportunity zone provision is all about moving capital into economically disadvantaged areas of the country, it is important to note that the statute requires that substantially all of the use of the QOZ property be located in a QOZ. More than 8,700 census tracts have been officially designated as QOZs. (More information on where the QOZs are located is available here.)

Although the statute technically provides that the designation of all QOZs will expire on December 31, 2028 (calling into question whether investors will benefit from the permanent exclusion of the post-acquisition economic appreciation for investments made in 2019 and later), the proposed regulations provide that the benefit remains available for sales of QOF investments until December 31, 2047.

The 90-Percent Asset Test

According to the statute, a QOF must hold at least 90 percent of its assets in QOZ property (the 90-percent test). Satisfaction of the 90-percent test is initially determined by averaging the percentage of QOZ property held in the fund as measured on the last day of the first six-month period of the taxable year of the fund with that held on the last day of the taxable year of the fund.

While the 90-percent test is fairly harsh for QOFs that plan on directly acquiring and improving QOZ business property, for those funds that plan instead to indirectly invest in such property by holding QOZ stock or partnership interests, the proposed regulations provide very significant relief in the form of a working capital safe harbor available only at the lower tier QOZ business level (discussed further below).

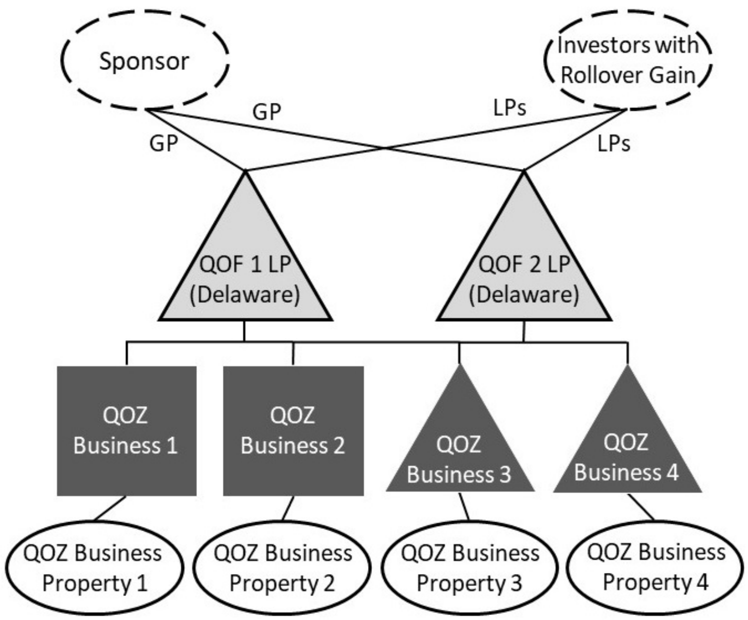
To become a QOF, an eligible entity must self-certify its compliance with the 90-percent test by filing a form attached to its U.S. Federal income tax return for the year (new Form 8996, Qualified Opportunity Fund). It must continue filing the form with its return annually to report that it meets the investment standard (or to calculate the penalty, if it does not). Fund sponsors should expect to be required to provide certain contractual comfort to investors in this regard in the limited partnership agreement or through side letter covenants.

Two-Tier QOF Structure

When it comes to QOF formation, most funds being created today follow a two-tier structure (so rather than having the QOF directly invest in QOZ business property, the QOF indirectly invests in such property by holding either stock or partnership interests in one or more QOZ businesses).

While a single purpose, single investor, single project fund may, in certain cases, more easily navigate the opportunity zone rules, the new working capital safe harbor and the extension of the QOZ designation to 2047 should go a long way toward providing flexibility to structure QOFs as traditional multiple asset pooled investment fund vehicles.

Potential QOF Holding Structure



Although the statute contains language that would appear to prohibit the creation of a fund-of-funds structure in the QOF context, there may be ways to navigate the prohibition. Specifically, while a QOF is defined as any investment vehicle organized as a corporation or partnership for the purpose of investing in QOZ property, it cannot invest in another QOF. That said, there is nothing in the statute to prohibit a QOF from investing in other partnerships or corporations that themselves are treated as QOZ businesses. Similarly, one QOZ business can invest in multiple businesses using disregarded subsidiaries as the operating businesses. Therefore, managers that are looking for outside QOFs to invest in their QOF would likely structure their fund to allow for outside QOFs and non-QOF electing cash investors to invest directly into their lower-tier QOZ businesses.

3. Fund Mechanics

Fund sponsors and their investors should expect that the trickiest part of the opportunity zone provision will be how quickly the rollover gains coming into the fund need to be invested in QOZ business property (either directly, in which case the 90-percent test applies, or indirectly, in which case the threshold is reduced so that substantially all—70 percent—of the tangible property owned or leased by the QOZ business must be QOZ business property).

QOZ businesses have three additional restrictions: (1) at least half of the business's total gross income must be derived from the active conduct of the business in the QOZ; (2) a substantial portion of the intangible property of the business must be used in the active conduct of the business in the QOZ; and (3) generally speaking, less than 5 percent of the property of the entity can be cash and cash equivalents.

Because of the strict language in the statute, conservative advisors had been telling funds that they only have six months to ensure that 90 percent of the invested gains have been spent on acquiring or improving QOZ property. It was thought that temporary cash reserves that have not yet been deployed (so-called working capital) would not count toward satisfying the 90-percent test.

The New Working Capital Safe Harbor

The proposed regulations provide welcome relief on this point by giving QOZ businesses a much longer period of time before the 5 percent limitation on their working capital (essentially cash and cash equivalents) is enforced. The limit—that the working capital assets be spent within 31 months—is relatively generous and is related to the amount of time the QOF or QOZ business has to substantially improve any QOZ business property that did not meet the so-called original use requirement (which generally provides that the original use of the property in the QOZ commenced with the QOF or QOZ business).

Certain contemporaneous documentation and substantiation requirements must be satisfied. In particular, the QOZ business must be able to specify a target property on which it will expend the working capital from the outset in a written schedule. And throughout the 31 months, the QOF still has to satisfy the 90-percent test and the QOZ business still has to satisfy its substantially all (70 percent) tangible property as QOZ business property requirement. As a result, the relief does not necessarily solve all of the complexities of managing compliance with the QOZ rules during a QOF's start-up period.

"Original Use" and "Substantial Improvement" Relief

In an even more surprising move, a concurrently issued revenue ruling provides that, while "land can never have its original use in a QOZ commencing with a QOF," a QOF is not required to substantially improve land in order for it to qualify as QOZ business property (i.e., land effectively is treated as "good" even if it not substantially improved).

Treasury explained its rationale as follows: "excluding the basis of land from the amount that needs to be doubled [in order to satisfy the substantial improvement requirement for a building] facilitates repurposing vacant buildings in qualified opportunity zones."

In addition, Treasury is soliciting comments on providing additional flexibility with respect to the "original use" requirement for both real property and other tangible property. (For example, if the property was abandoned or under-utilized for some period of time, might it be eligible to be considered original use?)

4. Contractual Exposure to Investors

While the opportunity zone provision offers many benefits for investors, it also carries some risks that will need to be allocated between fund sponsors and their investors in the QOF's governing documents. Specifically, for each month that a QOF fails the 90-percent test, the QOF itself is assessed a penalty equal to the product of (i) the amount by which the assets of the QOF fall short of the 90-percent test, and (ii) the IRS underpayment rate in effect for the month of the failure (this is generally the Federal short-term rate plus 3 percent).

Treasury may issue rules that give QOFs "a reasonable period of time to reinvest" proceeds from the sale of qualifying assets before the penalty will be triggered. Future regulations should also address the tax treatment of any gains that the QOF reinvests during that reasonable period. Such asset sales could give rise to gain that could be taxable to the QOF (if it is a corporation) or its investors (if it is a partnership), thus reducing the potential benefit of any permanent exclusion.